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No. 21,146 Vol 3392

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

v.

NATIONAL SECURITIES, INC., a corporation, NATIONAL LIFE & CASUALTY INSURANCE COMPANY, a corporation, ROBERT A. WALLACE, ROBERT C. BOHANNAN, JR., ARTHUR W. SAFFERT, TED WILKINS, JOHN S. BARRETT, JOSEPH B. SETTER, BREEFERD W. LARGE, JR. and PRODUCERS LIFE INSURANCE COMPANY, a corporation (also known as NATIONAL PRODUCERS LIFE INSURANCE COMPANY),

Defendants-Appellees.

APPEAL FROM UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ARIZONA (Phoenix Division)

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF-APPELLANT

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INDEX

TABLE OF CASES

Cases:

Cases—continued | Page

Cases—continued Page

Statutes and Rules:

No. 21,146

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF-APPELLANT

STATEMENT OF PLEADINGS AND JURISDICTION

This is an appeal under 28 U.S.C. 1291 by the plaintiff Securities and Exchange Commission from a final judgment of the United States District Court for the District of Arizona (Phoenix Division) granting judgment on the pleadings for the defendants-

appellees (R. 804).[1/] The action was brought pursuant to Section 21(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(e), to enjoin violations of the antifraud provisions of that Act, Section 10(b), 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5, and for other relief (R. 2, 12-14, 424, 440-442). The complaint alleges that the defendants, in the course of violating the Act, made use of the means and instrumentalities of interstate commerce and of the mails (R. 3, 425). The district court had jurisdiction under Section 27 of the Act, 15 U.S.C. 78aa (R. 2, 424).

STATEMENT OF THE CASE

Proceedings Below

The Commission's initial complaint for an injunction (R. 1-14) alleged, *inter alia*, that the defendants, National Securities, Inc., ("National Securities") and its subsidiary, National Life and Casualty Insurance Company ("National Life"), together with certain individual defendants who were officers and employees of National Securities, National Life, or both, had entered into a plan or scheme to obtain control of Producers Life Insurance Company ("Producers Life") and subsequently to bring about the consolidation of Producers Life and National Life in violation of Section 10(b) and Rule 10b-5

1/ References to the Record Appendix are cited as "R. ."

(R. 3-5).[2] The Commission at the time its complaint was filed moved for a temporary restraining order and a preliminary injunction because the plan was about to consummated (R. 15-16). The temporary restraining order was granted (R. 108-111). The defendants filed answers denying generally the allegations of the complaint (R. 170-177). They also moved that the temporary restraining order in part be vacated (R. 292-293). Their motion was granted (R. 293) and the questioned corporate consolidation of National Life and Producers Life was then ratified by their respective shareholders and approved by the Director of Insurance of the State of Arizona (R. 437-439).

The district court thereafter entered an order authorizing the Commission to "serve and file" an amended and supplemental complaint (R. 420) and the Commission filed such a complaint, re-alleging the violations previously set forth, together with several additional violations and subsequent developments, and asking in addition to injunctive relief that the defendants take whatever steps might be necessary to rectify the consequences of their unlawful conduct,

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2/ The complaint also named as defendants four of the former directors of Producers Life and a corporation they controlled, Producers Thrift & Loan Company ("Producers Thrift"), all referred to herein as "the selling directors." The complaint against these defendants was dismissed on their motion (R. 291) and a subsequent motion of the Commission (R. 494-495) to amend a later complaint to add them as parties defendant was denied (R. 793-794). No appeal has been taken from this denial. References to the defendants in the text relate only to the other defendants.

including an accounting and a readjustment of "the respective equities of the defendants and the stockholders of Producers Life" (R. 423-442; 441). The defendants filed an answer (R. 467-473) and moved for judgment on the pleadings or, in the alternative, for summary judgment (R. 474). On February 14, 1966, the court granted defendants' motion for judgment on the pleadings (R. 801).

The Allegations of the Amended and Supplemental Complaint

The Commission's Amended and Supplemental Complaint alleged that Producers Life had been an Arizona life insurance company, operating in that state and other western states (R. 424); it had 880,000 shares outstanding (including 50,203 of treasury stock), most of which were held by approximately 14,000 stockholders throughout the United States (R. 425, 431). The defendant National Life, also an Arizona life insurance company which operated in that state and other western states, was controlled by the defendant National Securities, a holding company which owned two-thirds of its stock (R. 424). According to the complaint, the defendants pursuant to a preconceived scheme and in violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder (1) purchased control of Producers Life, *inter alia*, by acquiring its treasury stock for a consideration which was designed to appear fair but which was in reality largely illusory because the defendants intended to and did reimpose obligations assumed by them in the purchase upon the

successor company into which they intended to consolidate Producers Life, and (2) solicited the approval of the stockholders of Producers Life to the plan of consolidation by means of material misrepresentations and omissions.

On April 27, 1964, it was alleged, National Securities first purchased 66,310 shares of Producers Life from four directors of the latter company (and Producers Thrift, their controlled company) for $942,769 in cash (R. 429). 3/ In addition, National Securities agreed to pay the selling directors $979,000 in monthly installments over a 10-year period for agreements not to compete with Producers Life in the future (R. 428-429). National Securities simultaneously purchased 50,203 shares of treasury stock of Producers Life for $114,964 in cash or $2.29 per share plus the assumption of certain of its outstanding liabilities in the amount of $627,891 or $12.50 per share, representing obligations of Producers Life to make payments for prior agreements not to compete (R. 428). 4/ It is alleged that at the time of these purchases the

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3/ National Securities purchased 27,416 shares of Producers Life stock from the four directors for $570,000 or approximately $20.79 per share, and 38,894 shares from Producers Thrift for $372,769, or approximately $9 per share (R. 429).

4/ Both the minutes of the board of directors meeting on April 27, 1964, at which Producers Life was authorized to sell the above treasury stock, and a management agreement by which Producers Life turned control of its operations over to National Securities, indicate that a consolidation of Producers Life into National Securities or its subsidiary was then contemplated (R. 41, 73).

defendants intended, as part of their unlawful scheme, to reimpose the initial obligation of payment of these assumed liabilities upon the successor to Producers Life after its planned consolidation with National Life, and thus relieve National Securities of any payments to be made upon these liabilities (R. 428). The shares of Producers Life so acquired, together with additional shares owned by National Securities, were transferred by National Securities to its subsidiary, National Life, for $1,114,964 in May 1964 (R. 430). When Producers Life was subsequently consolidated with National Life, the consolidated company assumed National Securities' obligations to the selling directors of Producers Life and the obligations, previously assumed by National Securities, to make payments for the prior agreements of Producers Life not to compete (R. 433-434). Prior to that time, through resignation of its former directors and appointment of certain of the individual defendants as directors by National Securities, the affairs of Producers Life had become completely dominated by National Securities (R.431), as were the affairs of National Life.

By virtue of paragraph 24 of the plan of consolidation of Producers Life and National Life, the successor company, National Producers Life Insurance Company ("National Producers"), was required to reimburse National Securities from gross revenues for any sums paid by the latter on the obligations it had incurred or assumed under the non-compete agreements. Through this plan National Securities would be reimbursed for a substantial part of its cost of Producers Life by payments from the company into which Producers Life was to be consolidated (R. 432-434).

The plan of consolidation was approved by the directors of the constituent companies and thereafter a communication soliciting proxies together with a copy of the consolidation agreement and a notice of the special stockholders meeting was mailed by the management of Producers Life to its 14,000 stockholders (R. 433). This communication and subsequent material (R. 433-439) sent to stockholders were alleged to have failed to disclose material information and to have contained false and misleading statements, including the following:

1. <u>Omission to Reveal Amounts Being Assumed by the Successor Corporation on the Non-Compete Agreements</u>. There was no disclosure of the amount owed by National Securities on the non-compete agreements — totalling over 1,400,000 dollars — which was to become a continuing charge against the income of National Producers (R. 433-434).

2. <u>Predicted 1965 Earnings and Omissions of 1964 Losses</u>. There were specific and repeated predictions that net income for National Producers would be $460,000 in the year 1965 (R. 435, 605, 624, 629). As late as February 23, 1965, it was represented (R. 636, 638):

> "Our projected profits from operations for 1965 of $460,000 are possible only through operational economies that can be effected as a result of the merger. This is twice the total profits for the past five years for Producers Life. Or, to put it another way, this is ten times the average annual profits of your company for that period. . . ."

National Life had a loss from operations of $35,657 for the year ending December 31, 1964, and Producers Life had a loss from operations of $69,716 for that year.[5/] After becoming aware of these losses and

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5/ Excerpts from Ex. 15, p. 47; excerpts from Ex. 13, p. 4.

without disclosing them, the defendants continued to solicit proxies to be voted in favor of the merger, referring to the $460,000 earnings prediction for 1965, which was based on 1963 income (R. 638). Statements of comparative income and losses for the two companies for the years 1959 through 1963 were also communicated to the stockholders in connection with the earnings prediction but no mention was made of the substantial losses suffered by both companies in the immediately preceding year (R. 437).

3. Inclusion of Treasury Stock as an Asset Value of $1,175,085.75 in the Pro Forma Balance Sheet of National Producers. An illusory asset of "Treasury Stock $1,174,556" was set forth in the pro forma balance sheet for National Producers (R. 435).

4. Concealment of Material Facts Relating to Valuation of Shares of Producers Life Held by National Life. In a comparative balance sheet sent to Producers Life stockholders on November 27, 1964, the stock of Producers Life held by National Life was listed as an asset of National Life valued at $1,174,556, the amount National Life had paid National Securities (R. 435). National Life reported this asset in its 1964 annual report to the Arizona Director of Insurance, however, at its December 31, 1964 market value of $641,668, and charged off $579,381 to surplus (R. 437; Excerpts from Ex. 14, p. 30A; Excerpts from Ex. 15, pp. 46, 51). This write-down was not disclosed in any of the communications sent after December 31, 1964, although defendants continued to solicit assents to the merger from the stockholders who had previously received the November 27, 1964 mailing.

<u>The Decision Below</u>

The district court, in granting defendants' motion for judgment on the pleadings, suggested that Section 10(b) of the Securities Exchange Act may not apply to proxy solicitations for "a shareholder-approved corporate consolidation and reorganization," and, although its order is not completely clear, it apparently held (1) that in any event "the McCarran [-Ferguson Insurance Regulation Act, 59 Stat. 33, 15 U.S.C. 1011-1015] . . . preclude[s] the application in this case of §10(b), as implemented by Rule 10b-5" and (2) that "an accounting for unjust enrichment and other relief" sought by the Commission "would, in all events, fall outside the scope of available relief provided in §21(e) of the 1934 Act. . ." (R. 798, 801).

STATUTES INVOLVED

Relevant portions of the Securities Exchange Act of 1934, 15 U.S.C. 78a, <u>et seq</u>., and of Rule 10b-5 promulgated thereunder, 17 CFR 240.10b-5, are printed in an appendix hereto (pages 1a-4a, <u>infra</u>). Also printed in the appendix are relevant portions of the McCarran-Ferguson Insurance Regulation Act, 15 U.S.C. 1011-1015.

SPECIFICATION OF ERRORS

1. The district court erred in granting defendants' motion for judgment on the pleadings on the ground that the McCarran Act precluded

the application of the antifraud provisions of the Securities Exchange Act, Section 10(b), and Rule 10b-5 thereunder.

2. The district court erred in holding that it could not grant relief to "rectify and correct the consequences" of defendants' unlawful conduct and that it would be inappropriate and outside the scope of relief afforded by the Securities Exchange Act for the court to grant, as part of the requested remedy, an accounting for unjust enrichment and other relief.

3. The district court erred to the extent it may have suggested that the fraudulent statements made in connection with the consolidation of Producers Life and National Life into National Producers and the fraudulent omissions in the purchase of Producers Life treasury stock were not "in connection with the purchase or sale" of securities within the meaning of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.

SUMMARY OF ARGUMENT

1. The McCarran Act was passed in 1945 to allay fears, based upon a Supreme Court decision 6/ in the prior year, that the regulation of the insurance business would henceforth be taken over by the federal government. It was not intended to, and did not, alter the applicability of the antifraud provisions of the federal securities laws to transactions

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6/ United States v. South-Eastern Underwriters Association, 322 U.S. 533 (1944).

in the capital stock of insurance companies. The exemptions relating to insurance are specifically stated in the federal securities laws; and in the important cases arising under those laws involving companies subject to state insurance regulation, the questions have related to such matters as whether a "variable annuity" is basically in the nature of an insurance policy or a security. The legislative history of the Securities Acts Amendments of 1964 makes clear that Congress considered the federal securities laws to be applicable to stock in insurance companies. In many cases, including criminal cases, involving charges of fraudulent sales of insurance company stock in violation of the federal securities laws it has not even been contended that the McCarran Act is applicable. While the question has been raised in other cases, except for the decision of the court below, it has never been held that the sale of insurance company stock was included within the "business of insurance" within the meaning of the McCarran Act.

2. The Supreme Court in *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964), held that, in an action brought under the same jurisdictional provisions as the instant case, the district courts have jurisdiction to grant the type of equitable relief sought here. In fact, the Supreme Court in its opinion admonished the courts "to be alert to provide" whatever remedies may be required to afford appropriate relief. That opinion is consistent with a long line of cases under the federal securities laws and other regulatory statutes which have authorized the

granting of equitable relief to the United States when it is seeking to vindicate the public interest, even though the governing statute does not specifically provide for the granting of such remedies.

3. The terms "purchase" and "sale" are broadly defined in the Securities Exchange Act so as to embrace transactions beyond the limitations applicable under the commercial law of sales. In a consolidation the definitions literally apply since the shareholder disposes of one security and acquires another. The complex nature of a consolidation may enhance the opportunities for fraud and, accordingly, the securities laws to afford relief in such situations must, as the Supreme Court has held, be construed flexibly to effectuate their remedial purposes. While this Court in dicta in a 1943 opinion agreed with the position urged by the Commission at that time in a brief <u>amicus curiae</u> that certain of the antifraud provisions of the Securities Act were not applicable to a corporate consolidation, the Commission since at least 1951 has consistently held that a merger or consolidation involves a purchase or sale of securities within the meaning of the antifraud provisions of the securities laws and has so informed this Court.

The purchase of treasury shares of Producers Life by National Securities, for a purported consideration which included an assumption of a substantial liability of Producers Life that National Securities intended to avoid by causing it to be assumed by the corporation into which it intended and did consolidate Producers Life, also violated Section 10(b) and Rule 10b-5.

ARGUMENT

I. THE McCARRAN ACT DOES NOT IMMUNIZE INSURANCE COMPANIES FROM THE PROVISIONS OF THE FEDERAL SECURITIES LAWS

The McCarran Act declares (15 U.S.C. 1011) that the "continued regulation and taxation by the several States of the business of insurance is in the public interest" and provides (15 U.S.C. 1012(b)) that "[n]o Act of Congress shall be construed to invalidate, impair or supersede" any state law enacted "for the purpose of regulating the business of insurance."

The Act was designed to allay fears, stemming from the Supreme Court's decision in _United States_ v. _South-Eastern Underwriters Association_, 322 U.S. 533 (1944), that the regulation of the insurance business, which had traditionally been a matter of state and local concern, would be henceforth taken over by the federal government. The Supreme Court's decision in that case had held that the business of insurance conducted across state lines was interstate commerce, with the result, _inter alia_, that insurance premium rates fixed by agreement could be charged as being in violation of the Sherman Act. The legislative history specifically stated that it was "not the intention of Congress in the enactment of . . . [the McCarran Act] to clothe the

States with any power to regulate or tax the business of insurance beyond that which they had been held to possess prior to the decision of the United States Supreme Court in the South-Eastern Underwriters Association case." H. Rep. No. 143, 79th Cong., 1st Sess. (1945) 3. In fact, Senator McCarran stated, "in other words, we give to the States no more powers than they previously had, and we take none from them." 91 Cong. Rec. 1442 (1945).

Appellants cannot contend that there was any question as to the application of the federal securities laws to the purchase and sale of securities of insurance companies prior to the passage of the McCarran Act in 1945. The only provisions respecting insurance in these laws related to an exemption from registration under the Securities Act of 1933[7/] for "[a]ny insurance or endowment policy or annuity contract or optional annuity contract" and to an exemption in the Investment Company Act of 1940[8/] to the effect that an insurance company is not an investment company. The troublesome questions that have been raised in this area relate not to whether transactions in the capital stock of insurance companies are subject to the federal securities laws but to whether a particular contract is an annuity policy or a security and whether an entity issuing such a contract is an insurance company or an investment

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7/ Section 3(a)(8), 15 U.S.C. 77c(a)(8).

8/ Section 3(c)(3), 15 U.S.C. 80a-3(c)(3).

company. See Securities and Exchange Commission v. Variable Annuity Life Insurance Co., 359 U.S. 65 (1959); Prudential Insurance Co. v. Securities and Exchange Commission, 326 F. 2d 383 (C.A. 3, 1964); Securities and Exchange Commission v. United Benefit Life Ins. Co., 359 F. 2d 619 (C.A. D.C., 1966), certiorari granted, 385 U.S. 918 (1966).

The Senate Committee on Banking and Currency recently had occasion to point out: "Stock insurance companies are presently subject to the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934."[9/] This statement was made in connection with amendments made in 1964 to the Securities Exchange Act, which required registration of the equity securities of the larger over-the-counter companies and extended reporting, proxy and insider-trading provisions to such companies. Securities Acts Amendments of 1964, 78 Stat. 565. From these provisions certain exemptions were made for those insurance companies which would be subject to certain state statutory requirements, since Congress believed such requirements would furnish protections to investors comparable to those imposed under the new law in the case of securities issued by other companies. These exemptions are limited solely to the new requirements relating to periodic reports, proxies, and insider-trading and do not purport to affect other requirements

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9/ S. Rep. No. 379, 88th Cong., 1st Sess. (1963) 36.

imposed by the various federal securities laws. The context in which these exemptions were made is clear from the Commission's statement filed with the House Committee on Interstate and Foreign Commerce during the hearings:

> "Historically, insurance companies have never been exempted from either the Securities Act of 1933 or the Securities Exchange Act of 1934. Under the Securities Act of 1933, an insurance company distributing its securities to the public must file a registration statement with the Commission and comply with all of the provisions of that act, in the same manner as any industrial company. Likewise, under the Securities Exchange Act, an insurance company listing a security on a national securities exchange must comply with all of the provisions of that act applicable to exchange-listed companies. Presently two insurance companies have a security so listed and comply with those provisions of the act. Moreover, section 15(d) of the Exchange Act, added to that act in 1936, is fully applicable to insurance companies. That section requires an issuer distributing its securities to the public under a Securities Act registration statement to file periodic financial and other reports with the Commission if the value of the securities offered plus the value of all other outstanding securities of the class offered exceeds $2 million. Under section 15(d), approximately 148 insurance companies, including about 96 life insurance companies, file periodic reports with the Commission. . . ." 10/

In most cases under the antifraud provisions of the Securities Exchange Act involving insurance companies no question respecting the

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10/ Hearings Before A Subcommittee of the House Committee on Interstate and Foreign Commerce on H.R. 6789, H.R. 6793, S. 1642, 88th Cong., 1st Sess. (1963) 176.

McCarran Act has even been raised.[11/] So far as we are aware, there have been only two decided cases, in addition to the instant case, where it has been contended that the McCarran Act exempted the sale of stock of insurance companies from the requirements of the federal securities laws: Securities and Exchange Commission v. American Founders Life Insurance Company of Denver, Colorado (Civ. Action No. 6021, D. Colo., order dated May 7, 1958) and United States v. Meade, 179 F. Supp. 868 (S.D. Ind., 1960). Both held that the McCarran Act did not apply. As pointed out in the American Founders case, "the offer for sale, sale and delivery of the capital stock of insurance companies is not 'the business of insurance' within the contemplation of . . . [the McCarran] Act, and thus the offer for sale, sale and delivery of such capital stock is not exempt from the operation of the Securities Act of 1933. . . ."[12/]

11/ United States v. National Union Life Insurance Company, S.E.C. Litigation Release No. 2058 (N.D. Ala., 1961) (conviction); Securities and Exchange Commission v. National Reserve Life Insurance Company, S.E.C. Litigation Release No. 2450 (D. Kan., 1962) (decree of permanent injunction); Securities and Exchange Commission v. Decker-Thompson Brokers, Inc., S.E.C. Litigation Release No. 1941 (W.D. La., 1961) (decree of permanent injunction). Brennan v. Midwestern United Life Insurance Company, CCH Fed. Sec. L.Rep. ¶ 91,817 (N.D. Ind., Civ. No. 1716, 1966).

There have been similar actions under the antifraud provisions of Section 17 of the Securities Act. United States v. McCune, S.E.C. Litigation Release No. 2319 (W.D. Wash., 1962); and Securities and Exchange Commission v. American Brokerage Corporation, S.E.C. Litigation Release No. 2615 (D. Wyo., 1963). In neither of these cases was the McCarran Act asserted as a defense.

12/ See also United States v. Sylvanus, 192 F. 2d 96 (C.A. 7, 1951) (Mail Fraud Statute, 18 U.S.C. 1341).

II. THE DISTRICT COURT ERRED IN FINDING THAT IT COULD NOT GRANT THE COMMISSION'S REQUEST FOR ANCILLARY RELIEF

As we have seen, the Commission attempted to enjoin the consolidation of Producers Life and National Life at a time when the stockholders of Producers Life were being subjected to misleading communications urging them to approve the consolidation. The court below appears to have held that, even if the defendants' actions were unlawful, because it vacated the temporary restraining order obtained by the Commission and permitted the consolidation to be effected, it is without power to grant relief which the Commission claims would "rectify and correct the consequences of the wrongful and unlawful conduct of defendants" (R. 796). The court states that such relief, including a "prayer for an accounting for unjust enrichment," would "be inappropriate . . . and would, in all events, fall outside the scope of available relief provided in § 21(e) of the 1934 Act. . . ." (R. 800-801.) 13/

A comparable situation existed in J. I. Case Co. v. Borak, 377 U.S. 426 (1964), where the plaintiff sought to enjoin a proposed merger, contending that materials circulated to obtain proxies were

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13/ Should this Court agree with the Commission that the court below had power to undo the consolidation or otherwise grant relief to prevent the defendants from remaining unjustly enriched by their unlawful activities at the expense of former stockholders of Producers Life, to the extent that the court below may have held (R. 800-801) that "an accounting for unjust enrichment" or "other relief" which the Commission sought would be inappropriate "to rectify and correct the consequences of the wrongful and unlawful conduct of defendants," the case could be remanded to the court below to determine what relief would be appropriate.

in violation of Section 14(a), 15 U.S.C. 78n(a), of the Securities Exchange Act and rules of the Commission thereunder, 17 CFR 240.14a-1 through 240.14a-12. Id. at 429. Upon plaintiff's failure to obtain injunctive relief, the merger was consummated. The district court held that it thereafter had no power to grant equitable relief or damages. 14/ The Court of Appeals reversed and was sustained by the Supreme Court, which emphasized that "it is the duty of courts to be alert to provide such remedies as are necessary to make effective the congressional purpose" and that the federal courts should "'adjust their remedies so as to grant the necessary relief' where federally secured rights are invaded." It held that Section 27 of the Securities Exchange Act, which "grants the District Courts jurisdiction 'of all suits in equity and actions at law brought to enforce any liability or duty created by this title. . .'" gave the district courts "power to grant all necessary remedial relief." Id. at 433, 435.

The court's jurisdiction in the instant case was also based on Section 27.

The holding in the Borak case is consistent with a long line of Supreme Court decisions to the effect that once the equitable jurisdiction of a court is invoked in an injunctive action, the court's

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14/ It suggested that the rule might be otherwise, however, in a suit brought by the Commission. See 377 U.S. at 430. There is no express provision in the Securities Exchange Act for injunctive relief by a private litigant but Section 21(e) provides for such relief in an action by the Commission.

general equity powers permit it to grant complete relief. E.g., United States v. Dupont, 366 U.S. 316, 334 (1961); United States v. Parke, Davis & Co., 362 U.S. 29, 48 (1960); Porter v. Warner Holding Co., 328 U.S. 395, 398 (1946); Yakus v. United States, 321 U.S. 414, 441 (1944); Virginian Ry. Co. v. Federation, 300 U.S. 515, 552 (1937). See also Camp v. Boyd, 229 U.S. 530, 551-552 (1913). And when the United States brings an enforcement proceeding in the public interest, all doubts about ancillary equitable remedies are to be resolved in its favor.[15]

Accordingly, equitable relief not specifically authorized by the securities laws has repeatedly been made available in actions based upon violations of these laws. Thus, in Deckert v. Independence Shares Corp., 311 U.S. 282 (1940), the Supreme Court held that rescission is a proper remedy under Section 12(2) of the Securities Act. And this Court has held that the general equity power of the district courts, without any specific statutory authority, authorizes the appointment of receivers under the securities laws at the request of the Commission. Securities and Exchange Commission v. Los Angeles Trust Deed & Mortgage

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15/ In Virginian Ry. Co. v. Federation, supra, the Supreme Court said (300 U.S. at 552):

> "Courts of equity may, and frequently do, go much farther both to give and withhold relief in furtherance of the public interest than they are accustomed to go when only private interests are involved."

Exchange, 285 F. 2d 162, 181-182 (1960), certiorari denied, 366 U.S. 919 (1961).[16/]

In any event at the very least, if the allegations made in the complaint are true, the Commission is entitled to an adjudication that the defendants' conduct violated Section 10(b) and Rule 10b-5, cf. United States v. Parke, Davis & Co., 362 U.S. 29, 48 (1960); and in this setting the Commission is also entitled to a decree enjoining the defendants from arranging or carrying out other consolidations or mergers through similarly deceptive methods.

III. DEFENDANTS' DECEPTIVE ACTS, CONDUCT AND COURSE OF BUSINESS, INCLUDING MAKING OF UNTRUE AND MISLEADING STATEMENTS TO SECURITY HOLDERS OF PRODUCERS LIFE AND CONCEALING MATERIAL FACTS FROM THEM, OCCURRED IN CONNECTION WITH PURCHASES AND SALES OF SECURITIES

In view of the district court's disposition of the case based on its application of the McCarran Act, it made no determination as to the application of Section 10(b) of the Securities Exchange Act or Rule 10b-5 thereunder to the facts alleged. Appellees, however, will presumably urge affirmance alternatively on the ground that even if, as alleged, the plan of consolidation, including the

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16/ See also, e.g., Lankenau v. Coggeshall & Hicks, 350 F.2d 61 (C.A. 2, 1965); Esbitt v. Dutch-American Mercantile Corp., 335 F.2d 141, 143 (C.A. 2, 1964); Aldred Investment Trust v. Securities and Exchange Commission, 151 F. 2d 254 (C.A. 1, 1945), certiorari denied, 326 U.S. 795 (1946); Securities and Exchange Commission v. H. S. Simmons & Co., 190 F. Supp. 432 (S.D. N.Y., 1961). See 3 Loss 1824-1829 (2d ed. 1961); Cary, Book Review, 75 Harv. L. Rev. 857, 861 (1962).

acquisition of the treasury stock of Producers Life was conceived in fraud and solicitation material sent to security holders of Producers Life was deceptive and misleading, the defendants' conduct was not in connection with the purchase or sale of any securities within the meaning of Section 10(b) and Rule 10b-5. Accordingly, a summary discussion of this point at this time appears appropriate.

A. Defendants' Fraudulent Statements Made in Connection with the Consolidation of Producers Life and National Life into National Producers were Made in Connection with Purchases and Sales of Securities

Section 3(a)(14) of the Securities Exchange Act, 15 U.S.C. 78c(a)(14), provides that a "sale" includes "any contract to sell or otherwise dispose of" securities and Section 3(a)(13), 15 U.S.C. 78c(a)(13), provides that a "purchase" includes "any contract to buy, purchase, or otherwise acquire" securities. Congress thereby made clear that these concepts embrace transactions beyond the limitations ordinarily applicable under the commercial law of sales in order to effectuate a primary purpose of the Act expressed in Section 2, 15 U.S.C. 78b, to make the "regulation and control" of transactions in securities "reasonably complete and effective." When, as here, a shareholder votes on a proposal for consolidation, he is being asked to decide whether to consent to the acceptance of a new security—a security of a new and different company—in exchange for the security he holds. When the consolidation is approved and the exchange of securities

occurs,[17] he has, in fact, disposed of one security and acquired another.[18] Accordingly, there has been both a purchase and sale within the meaning of the statutory definitions quoted from above.[19]

17/ Under the terms of the consolidation agreement, each stockholder of Producers Life was to receive, as a stock dividend, one share of Producers Life stock for every five shares owned by such stockholder. The ratification of this stock dividend by the stockholders of Producers Life was made a condition precedent to the execution of the consolidation agreement. The agreement further provided that each shareholder of National Life would receive one share of Producers Life stock for each share of National Life owned by him. The consolidation agreement, in addition, provided that the consolidated company would be known as National Producers Life Insurance Company. Although the shareholders of Producers Life did not actually surrender their shares, upon the execution of the consolidation agreement their interests and rights were materially changed (R. 446-447).

18/ _Cf_. _Hooper_ v. _Mountain States Securities Corp._, 282 F. 2d 195 (1960), _certiorari denied_, 365 U.S. 814 (1961), where the Court of Appeals for the Fifth Circuit held that a violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 was perpetrated upon a corporation which exchanged its shares for certain property. The court there stated (282 F. 2d at 203):

> "If this is not a sale in the strict common law traditional sense, it certainly amounted to an arrangement in which Consolidated 'otherwise dispose[d] of' its stock. § 3(a)(14), 15 U.S.C.A. § 78c(a)(14)."

19/ This is also consistent with the use of the verb "include" in the definitions of both "sale" and "purchase" in Section 3(a)(13) and (14) of the Securities Exchange Act, as contrasted to the more limiting verb "means," which is used in most of the definitions set forth in Section 3(a). See Russell, _Legislative Drafting and Forms_ (4th ed. 1938) 40.

The need for the antifraud protections is no less in such a situation than it is in the case of other types of purchases or sales. Indeed, the complex nature of a merger may enhance the opportunities for fraud and thus makes the need for the antifraud protections even greater than in other situations. A primary purpose of the Securities Exchange Act is "to keep the channels of interstate commerce, the mail[s], and national security exchanges pure from fraudulent schemes, tricks, devices, and all forms of manipulation." Hooper v. Mountain States Securities Corporation, supra, 282 F.2d at 202. This purpose would be thwarted if the protections for investors afforded by Section 10(b) and Rule 10b-5 could be avoided by the formalistic view that there was no purchase of the stock of Producers Life nor sale of the stock of National Producers in the consolidation here involved. The Supreme Court has held that the securities laws must be construed "not technically and restrictively, but flexibly to effectuate . . . [their] remedial purposes." Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963). See also Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293, 301 (1946). And see Errion v. Connell, 236 F.2d 447 (1956), where this Court held that the Securities Exchange Act created a federal remedy for one who has been defrauded in the sale of his securities.

In the court below the appellees urged that Section 10(b) and Rule 10b-5 did not apply because of this Court's position in National Supply Co. v. Leland Stanford Jr. University, 134 F.2d 689 (1943), certiorari denied, 320 U.S. 773 (1943), which was in accord with the views expressed to this Court by the Commission. In that case this Court held that the plaintiff was estopped by reason of laches from objecting to the corporate consolidation involved. In addition, it stated, "Without going into the matter, we may say that we are in accord with the views of the Commission," 134 F.2d at 694; these had been expressed in an *amicus curiae* brief which took the position that the corporate consolidation there involved was not a "sale" of securities giving rise to a private cause of action under Sections 12(1) and (2) of the Securities Act of 1933, 15 U.S.C. 77l(1) and (2). While an action under Section 12(2) of that Act is based upon fraud in the sale of securities, at least since 1951 the Commission has consistently taken the position that a merger or consolidation involves a sale of securities within the meaning of the antifraud provisions of the

federal securities laws.[20] This is in contrast to the registration provisions of the Securities Act, as to which the Commission has by rule provided that certain mergers and consolidations shall not be

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20/ In 1962 the Commission stated to this Court in an amicus curiae brief (p. 8) filed in Sawyer v. Pioneer Mill Company, 300 F.2d 200 (1962), certiorari denied, 371 U.S. 814 (1962):

> "It is the opinion of the Commission that exchanges of securities to effect a corporate merger, such as those involved in this case, constitute purchases and sales of securities within the meaning of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder; that neither the language, the rationale nor the purpose of the 'no-sale' rule requires its application here; and to apply the rule to exclude false and misleading solicitations of stockholders' approval for an exchange of their securities from the protection of the anti-fraud provisions of Rule 10b-5 contravenes the congressional intent and exposes public investors to serious risks of loss."

This Court did not reach that question, although re-argument en banc was ordered, possibly because consideration was being given to overruling the above quoted language of the Leland Stanford case. See Ellis v. Carter, 291 F.2d. 270 (C.A. 9, 1961).

deemed to involve sales of securities.[21/] Apart from the brief statement of this Court in the Leland Stanford case, so far as we are

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21/ From 1935 to 1947 the Commission's position that mergers are not subject to the registration provisions appeared in the Note to Rule 5 of Form E-1. In 1947, Form E-1 and the Note were rescinded but the Commission continued its policy of not requiring registration in the case of mergers. Since 1951 mergers have been excluded from the coverage of the registration provisions by the Commission's Rule 133 under the Securities Act, 17 CFR 230.133. The Commission's release adopting Rule 133 states:

> "As a matter of statutory construction the Commission does not deem the 'no sale theory' which is described in the rule as being applicable for purposes of any of the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934."

Securities Act Release No. 3420, p. 1 (1951). See also Securities Act Release Nos. 3698 (1956), 3762 (1957); E.I. DuPont de Nemours and Co., 34 S.E.C. 531, 533 n. 2 (1953); 1 Loss Securities Regulation 520-21 (2d ed. 1961).

It has been pointed out that under the Securities Act of 1933 "the word 'sell' may have a narrower meaning . . ." in the registration provisions than in other sections of that Act. See Schillner v. H. Vaughan Clarke & Co., 134 F. 2d 875, 878 (C.A. 2, 1943). The court there pointed out:

> "The broad definition set out in Section 2 [of the Securities Act, 15 U.S.C. 77b] is to be accorded 'unless the context otherwise requires.'"

The exemption from registration for certain judicially-approved reorganizations in Section 3(a)(10) of the Securities Act, 15 U.S.C. 77c(a)(10), suggests that at least in the absence of a rule, even under the registration provisions a merger may be considered a sale of securities. In this connection, the House Report on the Securities Act stated with respect to this provision as it appeared in an earlier draft:

> "Reorganizations carried out without such judicial supervision possess all the dangers implicit in the issuance of new securities and are, therefore, not exempt from the Act. For the same reason the provision is not broad enough to include mergers or consolidations of corporations entered into without judicial supervision." H. Rep. No. 85, 73d Cong., 1st Sess. (1933), p. 16.

aware no appellate court has directly dealt with the question whether the Commission's long-standing interpretation that the antifraud provisions of the securities laws are applicable to mergers and consolidations and should be upheld. 22/ We urge this Court to adopt the Commission's position to the end that the antifraud provisions of Section 10(b) and Rule 10b-5 will be available to protect public security holders, as we believe Congress intended, whenever they are required to make investment decisions which will result in a change in their securities holdings.

B. Defendants' Failure to Disclose that National Securities Intended to Reimpose the Payment of the Liabilities It Had Agreed to Assume as Part of the Consideration for Its Purchases of Producers Life Treasury Stock Constituted a Violation of Section 10(b) and Rule 10b-5

As we noted above (pp. 5-6), defendants did not disclose to Producers Life or its shareholders at the time National Securities purchased the treasury stock of Producers Life that the defendants did not intend to pay a major portion of the purported consideration. Aside from the $2.29 per share in cash, the balance of the consideration consisting of National Securities' assumption of certain of Producers

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22/ Two cases are pending in the Courts of Appeals from the decisions of two district courts which have taken a position contrary to the Commission. Dasho v. The Susquehanna Corporation (N.D. Ill., No. 65 C 1757, April 15, 1966, rehearing denied, June 28, 1966), appeal pending, (C.A. 7); Vine v. Beneficial Finance Co., Inc., 252 F. Supp. 212 (S.D. N.Y., 1966), appeal pending, (C.A. 2). Other district courts which have considered the question have agreed with the Commission. Simon v. New Haven Board & Carton Co., 250 F. Supp. 297 (D. Conn., 1966); Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369 (D. Del., 1965); Securities and Exchange Commission v. Anaconda Lead & Silver Co. (D. Colo., No. 6819, July 11, 1961). Contra, Sawyer v. Pioneer Mill Co., 190 F. Supp. 21 (D. Hawaii, 1960), vacated as moot, 300 F.2d 200 (C.A. 9, 1962), certiorari denied, 371 U.S. 814 (1962). Cf. H. L. Green Co. v. Childree, 185 F. Supp. 95 (S.D. N.Y., 1960).

Life's liabilities in the amount of $12.50 per share was to be reimposed upon the successor of Producers Life when the consolidation became effective. Such non-disclosure comes within the prohibitions of Rule 10b-5 respecting omissions "to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . ." or respecting an "act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. . . ." Fraudulent statements made in connection with the consideration given in a securities transaction have been held by this Court to consitute a violation of Section 10(b) and Rule 10b-5. Errion v. Connell, supra, 236 F.2d at 454 (1956). And, even if there is total non-disclosure, Rule 10b-5 may be violated. See List v. Fashion Park, Inc., 340 F.2d 457, 461-462 (C.A. 2, 1965), certiorari denied, 382 U.S. 811 (1965).

Both the United States Courts of Appeals for the Fifth Circuit and for the Second Circuit have held that where a corporation has been fraudulently induced to issue its own shares, a violation of Section 10(b) and Rule 10b-5 has occurred. Hooper v. Mountain States Securities Corporation, supra, 282 F.2d at 200-203; Ruckle v. Roto American Corp., 339 F.2d 24, 26 (C.A. 2, 1964). See also New Park Mining Co. v. Cranmer, 225 F. Supp. 261, 266 (S.D. N.Y., 1963); Pettit v. American Stock Exchange, 217 F. Supp. 21, 25-26 (S.D. N.Y., 1963). That directors of Producers Life may have been aware that defendants intended to reimpose

the assumed liabilities upon the shareholders of the successor to Producers Life, does not affect the end result that a fraud has been committed upon Producers Life and its shareholders. Cf., Hooper v. Mountain States Securities Corporation, supra, 282 F.2d at 201; McClure v. Borne Chemical Co., 292 F. 2d 824, 834 (C.A. 3, 1961), certiorari denied, 368 U.S. 939 (1961). But cf., O'Neill v. Maytag, 339 F. 2d 764 (C.A. 2, 1964).23/

* * *

In the light of the "broad fiduciary duties on management vis-a-vis the corporation and its individual stockholders" imposed by Section 10(b) of the Act, as implemented by Rule 10b-5,24/ it would be unfortunate if this Court should hold that the terms "sale" and "purchase" must be so narrowly construed that the Act and Rule fail to implement the congressional intent to prohibit the type of fraudulent scheme here alleged.

23/ While we submit that O'Neill v. Maytag was wrongly decided, we believe that it is distinguishable since in that case the court found that all of the directors had participated in the alleged fraud. Here the Commission's Amended and Supplemental Complaint (R. 430) did not allege that all of the directors were aware of defendants' unlawful scheme. Indeed, one director, J. Grant Iverson, was not even present at the meeting of April 27, 1964, at which the sale of the treasury stock was authorized. See Ruckle v. Roto American Corp., supra, 339 F.2d at 26-27, where the court held that the corporation had been deceived when the majority of the board of directors withheld current financial information from a fellow director and failed to disclose other material facts to him.

24/ McClure v. Borne Chemical Co., supra, 292 F.2d at 834.

CONCLUSION

For the foregoing reasons the judgment of the district court should be vacated and the case remanded to that court for further proceedings.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

David Ferber
Solicitor

February 1967

APPENDIX

Securities Exchange Act of 1934, 15 U.S.C. 78a, et seq.:

* * * *

Definitions and Application of Title

SECTION 3. (a) When used in this title, unless the context otherwise requires—

* * * *

(13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.

(14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of.

* * * *

REGULATION OF THE USE OF MANIPULATIVE AND DECEPTIVE DEVICES

SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--

* * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * * *

INVESTIGATIONS; INJUNCTIONS AND PROSECUTION OF OFFENSES

SECTION 21.

*   *   *   *

(e) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title.

*   *   *   *

Jurisdiction of Offenses and Suits

SECTION 27. The district courts of the United States, the United States District Court for the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347). No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against it in the Supreme Court or such other courts.

2. McCarran-Ferguson Insurance Regulation Act, 15 U.S.C. 1011-1015:

* * * *

Section 1012, 15 U.S.C. 1012:

(a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: Provided, that after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

* * * *

3. Rule 10b-5 under the Securities Exchange Act of 1934, 17 CFR 240.10b-5:

EMPLOYMENT OF MANIPULATIVE AND DECEPTIVE DEVICES

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

No. 21,146

In the

United States Court of Appeals

for the Ninth Circuit

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellant,
vs.
NATIONAL SECURITIES, INC., a corporation, et al,
Defendants-Appellees.

Brief of Appellees

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SUBJECT INDEX

TABLE OF AUTHORITIES

STATUTES AND RULES

MISCELLANEOUS

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Defendants-Appellees.

Brief of Appellees

JURISDICTION

This is an action for equitable relief filed by the Securities and Exchange Commission under Section 10(b) of the Securities Act of 1934, 15 U.S.C. Sec. 78j(b), and Rule 10b-5 of the Commission, 17 CFR Sec. 240.10b-5 (R. 1). The issues were presented to the trial court on an answer (R. 467) and motion for judgment on the pleadings (R. 474), which was granted (R. 795). The District Court has jurisdiction in cases of this type under 15 U.S.C. Sec. 78aa; jurisdiction is challenged in this particular case for want of indispensable parties, see Rule 19, Fed. R. Civ. P. This Court has jurisdiction under 28 U.S.C. Sec. 1291.

STATEMENT OF CASE

A. Introduction.

This was a suit by the SEC originally brought in 1965 to block the merger of two Arizona insurance companies. On the original complaint (R. 1) the SEC obtained an ex parte temporary restraining order (R. 108). However, the restraining order was almost entirely quashed (R. 292), eliminating all operative parts which would have affected the merger. The merger thereupon went through. The Commission then filed a supplemental complaint for an injunction (R. 423) which was duly answered (R. 467).

The defendants moved for judgment on the pleadings or in the alternative for summary judgment (R. 474), and the judgment on the pleadings was granted (see the court's discussion of the remedy, par. 2, R. 795).

Behind the 1965 merger was a 1964 stock acquisition, and each of these relates to the case.

1. STOCK ACQUISITION.

In April, 1964, a leading Arizona insurance company was National Life & Casualty Insurance Company (National Life), held to the extent of a controlling interest by a holding company, National Securities, Inc. (National Securities). A second and even larger Arizona insurance company, then wholly unconnected with National Life, was Producers Life Insurance Company (Producers). Producers administration was in the hands of a group of directors and shareholders largely known for purposes of this case as the Johnson group. National Securities bought out the Johnson group. It was a complex transaction involving over $1,500,-000, and numerous separate transfers were involved (R. 71). Few of the details of the sale matter for purposes of this lawsuit.

The practical effect of the transaction when it was completed was that National Securities continued to control National Life and had a 13.2 per cent interest in Producers (R. 41). A management agreement whereby National Securities would manage Producers was promptly agreed to (R. 73).

2. THE MERGER.

The SEC says that a merger of National Life and Producers was contemplated from the beginning. National Securities says otherwise, and the relevant materials pro and con are appended in a note.* But, regardless of when

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*The inference by the SEC that the merger of National Life into Producers was intended on April 27, 1964, is unwarranted. The fact that the original intent of National Secruities was not to effect a merger between National Life and Producers is evidenced by the minutes of April 27, 1964 (R. 41-42) and by the management agreement itself, distributed to all stockholders, under which National Securities anticipated an assumption of substantially all assets of Producers and assumption of all of its liabilities; pending this result, the management agreement was executed providing for the operation of Producers (R. 73). Under this agreement National Securities guaranteed the stockholders of Producers a certain profit, as was set forth in the mailings; See R. 621. In fact, National Securities did pay certain amounts to Producers the first year under this guarantee (R. 718).

Had the original plan been followed, and had National Securities acquired all of the assets of Producers in exchange for stock, it could have well afforded to pay all amounts required to be paid under the non-compete agreements fully described elsewhere in this brief. The later agreement to cancel the management agreement was the product of dissident stockholder dissatisfaction with it; See, for allusion R. 126. In consequence of this drastic reorganization of the original plan of National Securities, National Producers agreed to reimburse National Securities for non-compete payments which National Securities would have made had not the original plan to acquire the assets of Producers been modified.

The minutes of the April 27, 1964 directors meeting read as follows:

> "He [Mr. Wallace] noted further that it was the intent of National Securities that subsequently one form or another of corporate reorganization or amalgamation be proposed to the stockholders of Producers. He stated that at the present time

the idea dawned, the two companies were merged. A.R.S. Sec. 20-731 provides that insurance companies may "merge or consolidate" by complying with the general law on that subject, which in turn requires the agreement of two-thirds of the shareholders of each corporation to agree. However, the insurance provision adds a requirement of approval by the Director of Insurance and gives him the duty of examining into the merits of the merger. The intention to merge National Life and Producers was announced prior to July, 1965 (the merger date), and the steps necessary to merge two Arizona insurance companies were followed (*e.g.*, R. 800).

Even with the tight limitations of a motion for judgment on the pleadings, this record shows that there was a very vigorous controversy within Producers as to whether or not to agree to the merger. (See, *e.g.*, the Merger Fact Book,

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> he felt it was not particularly important to determine precisely the method to be chosen so long as it was clear that the stockholders of Producers would, at the appropriate time, have proposed to them a specific plan for reorganization as a result of which they would formally join the National Securities group, and be offered the opportunity to convert their present holdings to shares of the Common Stock of National Securities." (R. 41, 42).

The actual merger of National Life into Producers did not convert the holdings of Producers stockholders into shares of Common Stock of National Securities. These holders continued as stockholders of Producers, the surviving company. The Management Agreement between National Securities and Producers also cited by the SEC as authority for its inference, provides as follows:

> "WHEREAS National [National Securities] and Producers each desire at some future date and during the term of this agreement to propose to the appropriate stockholders a corporate reorganization or amalgamation wherein and whereby National directly, or indirectly through its subsidiaries now or hereafter existing, shall acquire ownership of all the assets and assume all the liabilities of Producers;" (R. 73).

As a result of the merger the ownership of National Securities in the surviving corporation, National Producers, was approximately 36 per cent, substantially less than all the assets and all the liabilities of Producers. (R. 718).

R. 620). There was a hard-hitting proxy solicitation campaign, with much solicitation material. (R. 567 *et seq., passim.*)

After the operative portions of the SEC's ex parte restraining order were quashed by the Federal District Court, the merger was consummated by the shareholders. The favorable stockholder vote was "overwhelming," the favorable vote running over 75 per cent of all shareholders (R. 437-38, reference to par. 34 of amended complaint); the percentage of those actually voting was much higher. It was expressly approved by the Arizona Director of Insurance (R. 800). The surviving insurance company has since functioned as National Producers Life Insurance Company (National Producers).

B. This Litigation.

1. THE SUIT AND ITS CHARGES.

On March 30, 1965, the SEC filed this action and obtained an ex parte restraining order (R. 108-11), the practical effect of which was to enjoin the merger. The original parties were the National Securities group and its officers (by now including Producers and National Life) and the sellers or Johnson group. The charge was Violation of Section 10(b) of the Securities Exchange Act of 1934 (Act), and Rule 10b-5 issued under it. Section 10(b) has no independent importance for purposes of this case; it simply gives basis for the regulation. The regulation makes it unlawful to make any untrue statements or misleading omissions or employ fraudulent schemes "*in connection with the purchase or sale of any security.*"

(a) Original Charges.

We thus come to the substance of the SEC's original charge:

(i) In the original sale of April, 1964, the members of the selling (Johnson) group in various ways breached their fiduciary duties to Producers (R. 6-7). The National Securities group, or purchasers (who are not suggested to have been "insiders" as to Producers), allegedly assisted in this.

(ii) The resultant merger of the two insurace companies was allegedly unfair to Producers, and the proxy solicitations for the merger did not divulge to the shareholders material facts as to the merger.

The errors and omissions asserted in the proxy solicitation (R. 9-11) are the heart of the complaint. Reduced to a sentence, the charge is that Producers was victimized in two interrelated ways: (a) By the selling group, which sold control improperly; (b) By the National Securities group, which allegedly failed to disclose certain material facts in Producers merger proxy solicitations.

We do not stop to analyze the actual underlying charges for two reasons: (a) As will be developed below, the charges against the Johnson group were dropped from the case. There has been no suggestion in this record, nor could there be, that the National Securities group has anything whatever to do with the Johnson group except that they bought what the Johnson group sold. We therefore have no occasion to speak for that group, nor reason to do so. (b) The existence or nonexistence of the alleged frauds is viewed by defendants as immaterial to the decision of the court below. We shall develop the precise issues and precise grounds for decision in a moment; they go to the scope of Rule 10b-5 and to the interrelations of the McCarran Act and the Arizona Insurance Code. Hence the question of whether the statements in the solicitations were misleading is simply immaterial; the court below did not pass on this.

We appreciate the familiar doctrine of legal gamesmanship that the equities may in truth control even technical matters of statutory interpretation. We believe that there were no fraudulent or misleading or devious statements or nonstatements of any kind. The allegations to the contrary by the SEC are totally denied in the pleadings and, we contended below, the record demonstrates the allegation to be incorrect. Nonetheless we confine that part of the discussion to a footnote in order to emphasize the defendants' main position: On the face of the complaint—on the pleadings—there is no violation of law.*

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*The Commission makes four specific complaints (Br. p. 7-8). Item 1 is an allegation that the amount involved in the assumption of noncompete agreements was not disclosed. The noncompete agreements were a well known part of the history of Producers. The fact that they were to be assumed was set forth extensively in the Consolidation Agreement (R. 85) distributed to every shareholder. While dollar figures were not used, no one needed to be in doubt about the hard facts.

The SEC's second claim is that there was an improper projection of profits for 1965. This projection of $460,000 was in fact reasonable when made, having been based on 1963 income. 1966 profits, though not in this record, were about $220,000. Moreover, the charge overlooks the fact that the whole picture was presented; for example, annual figures from 1959-1963, showing profits and losses, for both companies, were given to the shareholders; see *e.g.*, R. 137.

The third complaint is that certain treasury stock was assigned an asset value and National Securities believes the valuation to have been based on sound accounting principles. The fourth contention relates to the accounting treatment of certain shares of Producers in a report to the Arizona Director of Insurance. This wholly overlooks the special requirements for insurance accounting and the fact that this particular treatment was expressly approved by the Arizona Director (R. 477).

The thinness of these charges as contained in its present Brief is confirmation of their afterthought quality. The actual temporary restraining order originally obtained in this case, and filed with the original complaint, is based upon a thirty-paragraph affidavit of W. Stevens Tucker, which at R. 30-32 (par. 25-29) itemizes the dissatisfactions of the SEC with the proxy solicitation. *Not a single one of the four points which the Commission brings to this Court was in fact included in the Tucker affidavit,* which between courts seeks to change ground altogether.

(b) A Subsequent Charge.

On April 27, 1964, when the purchase was made by the National Securities group, it bought certain treasury stock from Producers as an incident of the whole transaction. It paid for that stock partly in cash and partly by the assumption of certain previous obligations of Producers known as the Pound noncompete agreements (R. 60). It did on the same day enter into a management agreement with Producers whereby managerial functions of Producers would be undertaken by National Securities (R. 73).

In the later Consolidation Agreement of National Life and Producers, the Pound noncompete agreements were assumed by National Producers. The management contract, and with it the possible benefits thereunder to National Securities, was cancelled (R. 79).

In its original complaint in this action, the SEC alleged that on April 27, at the time of the transaction, National Securities and National Life intended to cause Producers Life and National Life, after a merger or consolidation, to reimburse National Securities for the moneys involved in the Pound noncompete agreements (par. 6, R. 6). In the amended complaint, this same allegation was carried forward (par. 5, R. 428).

Neither complaint asks any specific relief directed at any contention that there was somehow something wrong about this series of events. No argument based on the paragraphs just identified was offered to the District Court; this claim is simply not mentioned.* In its brief to this Court, the Commission argues (R. 28-30) that the failure of National Securities to advise Producers when it was making this purchase on April 27, 1964, of some alleged intent in respect

*To avoid duplication, we reserve discussion of the assignments of error on this point for the Agreement.

to the Pound noncompete agreements, is a violation of Rule 10b-5.

2. THE PROCEEDINGS BELOW: FROM TEMPORARY RESTRAINING ORDER TO AMENDED PLEADINGS.

The National Securities defendants answered on April 15, 1965 (R. 170-78). They denied any jurisdiction on the matter and also denied all allegations of misdeeds.

The matter came on before Judge Mathes sitting in Phoenix. On April 16, 1965, he granted a motion to drop the Johnson group from the case (R. 291) without prejudice to the Commission's right later to move to plead them in again.

On motion of the National Securities group, the court deleted from the temporary restraining order all the general language, eliminating every part which would have precluded the merger (Order, R. 292). The SEC did not move for any stay of this cancellation of the operative portions of the temporary restraining order nor did it apply to this Court for any relief. In those circumstances, as already noted, the merger was voted by the shareholders, was approved by the Director of Insurance, and became effective.

The matter came up again before Judge Mathes in July of 1965 in San Francisco. Cross application for orders of complete dismissal of the case by the defendants and for further proceedings on the application for preliminary injunction by the SEC were put aside, the court simply giving the Commission 30 days within which to file an amended and supplemental complaint if it desired to do so (R. 419-21).*

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*We do not have the transcript of this proceedings and therefore can only avow that Judge Mathes in essence gave the Commission its choice of having the case dismissed at that time or of amending to show the merger so that on appeal to this Court the Commission could present the actual situation. This is detailed in defendants' summary of the events, R. 507-08, which is no way controverted.

Thereafter, on August 1, 1965, the SEC filed its amended and supplemental complaint for injunction (R. 423). The two most substantial differences between this 20-page document and its predecessor were:

(a) This complaint did not include as defendants any members of the Johnson group. Nonetheless it alleged that those nonparty persons had proceeded in contravention of their fiduciary duties by selling to the National Securities group (R. 430).* The complaint is shot through with allegations concerning "the selling directors" and the complaint expressly prays that the acts of the defendants "in concert with the selling directors" be declared to be illegal (R. 425, 427). The court is asked to declare fraudulent the contracts between the Johnson group and the defendants (R. 440).†

(b) The merger having been accomplished, it could no longer be enjoined; the prayer for relief in essence calls upon the defendants to undo it.

3. THE PROCEEDINGS BELOW: PARTIES.

Since the amended complaint called upon the court to declare illegal transactions of persons not parties to the cause,

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*"12. The selling directors, in carrying out and executing the transactions described above, and thereby enriching themselves, were acting in concert with the defendants and in contravention of their fiduciary obligations to the stockholders of Producers Life as a group, and such selling directors knew or should have known that the defendants were engaged in accomplishing a device and scheme to effect a merger or consolidation of Producers Life and National Life for the benefit and advantage of National Securities or to accomplish some other similar arrangement for the benefit and advantage of National Securities." (R. 430)

†"1. That the Court determine and adjudicate that the occurrences described in Section III above constituted a device, scheme and artifice to defraud and a series of acts, practices and a course of business, in connection with the purchase and sale of securities, which were accomplished by the defendants in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 17 CFR 240.10b-5." (R. 440)

the answer of the National Securities defendants expressly raised the absence of indispensable parties (R. 467). Apparently in recognition of at least some force to this challenge, the Commission moved to add the Johnson group (R. 494), by way of a tender of a second amended complaint (R. 498). The National Securities group opposed this motion (R. 507-09) on the ground that it came too late. These defendants contended that the court, in permitting the Commission to amend at all, was simply giving it leave to show the actual fact of the merger so that it might appeal, if it desired to do so, on the basis of the actual facts. Defendants contended that this privilege had been abused by "a whole series of new allegations directed not at National Securities but at the Johnson group." The National Securities group thus objected not only on the ground of want of indispensable parties but also on the ground that the SEC was not entitled to so many afterthoughts, and thus that the cause should be wound up.

4. THE PROCEEDINGS BELOW: ISSUES AND THE DECISION AS TO EACH.

National Securities presented several separate and independent grounds for judgment on the pleadings. The positions of the parties and the rulings of the court as to each are as follows:

(a) There can be a violation of Rule 10b-5 only where a "purchase or sale" of securities is involved. The defendants argued that a statutory merger of two insurance companies, even where certificates are exchanged, is not a "purchase or sale" as that term is used in the statute. The court below was not decisive on this point, although the import of its holding appears to be that this is not a "purchase or sale" case at all (Finding 7, R. 798).

(b) This is an action brought under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. A wholly different rule, Section 14 in the same Act and Rule 14(a)(9),

deal with proxy solicitation. The proxy solicitation rule clearly did not apply to these insurance companies under the law as it stood at the time of all relevant events. Amendments to the law might have made proxy requirements applicable later, but not in 1965. The defendants contended that the SEC was attempting to anticipate in this action legislation not yet operative. The trial court agreed and so held (Findings 4, 5 and 6, R. 797-98).*

(c) The McCarran Act provides that "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, . . ." (15 U.S.C. Sec. 1012(b)). Arizona law fully governs the merger of insurance companies, putting the duty of authorizing such mergers upon the Arizona Director of Insurance, subject to a right of appeal to Arizona courts. Here the Director had approved and there had been no appeal. Defendants contended that the effort of the SEC to invalidate a merger of two Arizona insurance companies would "impair" or "invalidate" or "supersede" Arizona state laws regulating the insurance business. The trial court agreed and held that the SEC's claim was barred by the McCarran Act (Findings 7-12, R. 798-800).

(d) The defendants contended that the relief sought was beyond the scope of that permitted under the statute, and the trial court agreed (Finding 13, R. 800-01).

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*Finding No. 5 is as follows: "5. Not until sometime during 1966 will the coverage of § 14 be extended, by virtue of the act of August 20, 1964 [78 Stat 569], to any corporation similarly situated to the insurance companies involved in this action; and then only if not exempted by new § 12(g)(2)(G) of the 1934 Act [15 U.S.C. § 78(1)(g)(2)(G)] which excludes 'any security issued by an insurance company' provided the insurance company is subject to certain defined State regulation;"

On the basis of the foregoing considerations, the trial court entered its judgment that the allegations in the pleadings failed to state a claim for which relief could be granted (R. 804). There were, however, other matters.

(e) The trial court denied the motion for leave to add additional parties (R. 793-94). It did not rest that conclusion upon the grounds of lateness which had been advanced by the defendants, set forth above, but rather held that on the merits no claim within the federal jurisdiction in an action could be brought by the SEC against those defendants (R. 793-94).

(f) The defendants claimed that there was no showing of the necessary causal connection between any alleged complaints about the purchase in 1964 and the merger in 1965. The trial court did not deal with this subject.

(g) The defendants contended that there had been no breach of fiduciary duty by them, that there were no improper proxy solicitations, and that there had been no breach of duty of any kind. Since the trial court concluded that no matter was alleged as to which relief could be granted, none of these contentions had to be passed on.

(h) No reference was made to the SEC's argument in this Court relating to treasury stock because this argument had not been made below.

C. This Appeal.

The final judgment of the District Court was March 14, 1966 (R. 804). The time to file a record on appeal was twice extended by the Federal District Court (R. 809-10), running to July 26, 1966. The SEC did not appeal from the order of the trial court denying it the right to add the Johnson group, appealing only from the judgment of dismissal; see its Specification of Errors, Brief, p. 9; its Statement of Points (R. 820) and the Commission's Brief in this Court,

p. 3, n. 2. The Commission was given until February 7, 1967, to file its opening Brief (see Special Order of Judge Chambers) and the case was referred to the April, 1967, calendar of this Court.

SUMMARY OF ARGUMENT

Taking the case as it stands on the pleadings, no violation of law is alleged. There is a preliminary jurisdictional question. The essence of the complaint is that a selling group and a buying group, in connection with the transaction between them, perpetrated some kind of a fraud. The complaint which was before the court below expressly called upon that court to find the sale and purchase fraudulent and illegal.

The members of the selling group, whose contract is thus attacked, are not before the court as parties. When the issue of indispensable parties was raised below, the Commission unsuccessfully sought to join them, and the Commission has not appealed the ruling denying them the right to do so. The selling parties are indispensable and the case must be dismissed on this ground; *State of Washington v. United States*, 87 F.2d 421 (9th Cir. 1936); *Hudson v. Newell*, 172 F.2d 848, 852 (5th Cir. 1949); *Young v. Powell*, 179 F.2d 147 (5th Cir. 1950); and see also *Interstate Commerce Commission v. Blue Diamond Prod. Co.*, 192 F.2d 43 (8th Cir. 1951).

The merger here attacked was accomplished under the Arizona statutes concerning the merger of insurance companies. The merger was expressly approved by the Arizona Director of Insurance. The SEC now asks the Federal Court to nullify the merger which was approved by the proper State authorities. Such an action would at least impair, if not invalidate or supersede, laws passed by the State of Arizona for the purpose of regulating the business of in-

surance, and this violates the McCarran Act, 15 U.S.C. Sections 1011-1015. The precise and detailed ways in which the order sought by the SEC would supersede State law are set forth in the Brief.

A statutory merger of two companies is not within the scope of Rule 10b-5 at all because that section applies only to the "purchase or sale" of securities. This underlying substantive question was decided by this Circuit in favor of the proposition that a merger is not a purchase or sale in *National Supply Co. v. Leland Stanford, Jr. University*, 134 F.2d 689 (9th Cir. 1943), *cert. denied*, 320 U.S. 773 (1943). In this case the Commission asks that "This court overrule or severely delimit" the *National Supply Co.* decision.

We believe that this Court should stand by its earlier decision. The suggestion that it be overruled comes with particular ill-grace from the Commission which, in that case, had recommended that the Court reach precisely the result which it did. The *National Supply Co.* decision has been followed by lower courts. It has been on the books for more than twenty years as the leading case on this exact point and Congress has never seen fit to alter it, nor, for that matter, has the Commission ever asked it to do so.

The decision of this Court was in accordance with the facts. There is no "purchase or sale" in connection with a statutory merger but simply a conversion of stock in the merged company into stock of the surviving company. The cases are fully considered in the brief following.

Wholly apart from the fact that the merger is not a purchase or sale and so is not governed by Rule 10b-5, the prime complaint of the SEC is of alleged misleading proxy materials used in connection with the merger. But Rule 10b-5 does not deal with proxy solicitations at all. Proxy solicita-

tions are governed by a wholly different section and a wholly different rule. Subsequent to the transactions involved here, Congress adopted and made effective amendments to that other section which at least might have the effect of controlling proxy solicitations in a case such as this one; but all of this is subsequent to the instant transaction. As the trial court stated, "The Commission is seeking to get a one-year jump on the recent statute by doing now precisely what it will be authorized to do" later. In the brief following, we contend to the Court that the cases hold that Rule 10b-5 does not apply to proxy solicitations at all. We also contend that the failure of the Commission to appeal or assign as error this portion of the decision of the court below, which it has not even briefed in this Court, leaves an independent ground for decision which, apart from any other consideration, would require affirmance of the trial court.

A contention is made by the Commission for the first time in this Court that the purchase of certain treasury stock is a violation of Rule 10b-5. This matter was not presented below, there is no decision concerning it, and appellees contend that the argument comes too late. And they contend further that in any case, it is without merit.

This is basically an action to nullify a merger. Appellees contend that there is no authority to nullify a merger in a suit brought by the SEC under Rule 10b-5.

ARGUMENT

I. Introduction.

Two Arizona insurance companies merged in 1965. The SEC instituted an action to enjoin the merger, but, unable to hold the ex parte temporary restraining order with which the suit began, the Commission took no other action to pre-

vent the merger before it was consummated. The Commission did not apply to this Court for a stay or enter an appearance before the Arizona Director of Insurance or use any other State remedies. The merger followed a very vigorous proxy fight in which all issues were completely ventilated, and the plan was adopted by a very heavy majority of the stockholders. It was approved by the Director of Insurance of Arizona, the officer charged with review of such matters.

We submit that the judgment of the trial court should be affirmed and that this matter should be put at rest.

II. The Suit Must Be Dismissed for Want of Indispensable Parties.

The point is simple but decisive. The Johnson group is indispensable in this action.

1. The original action included as defendants the sellers of Producers' stock (the Johnson group) and the buyers of it (the National Securities group). But the relief sought in that action, as originally filed, did not directly challenge the contractual relations between the parties; it aimed primarily forward, seeking to enjoin the merger. In these circumstances, the trial court saw fit to drop the Johnson group as defendants on their motion (R. 291).

2. But the amended complaint was very different. The amended complaint added a paragraph 12 (R. 430), set out verbatim in the Statement of Facts, expressly alleging that "the selling directors" were acting in contravention of fiduciary obligations and that they knew or should have known that the defendants were doing some improper act. Paragraph 1 of the prayer for relief in the amended complaint, also quoted above, expressly asks the court to determine that the various "occurrences," which is to say the contractual pattern between the Johnson group and the defendants, were illegal (R. 440).

The defendants forthwith pleaded a want of indispensable parties (R. 467). The SEC then offered a second amended complaint, seeking to cure the want of these parties by adding them (R. 494); but this the trial court refused to permit (R. 793), all as is more fully set forth in the Statement of Facts. There has been no appeal from this ruling. It is not specified as error, and the Commission's motion to add these parties in response to our insistence on their indispensability must be regarded as abandoned here; 9th Cir. R. 18(2)(d), 28 U.S.C.A.; *Dower v. United Airlines, Inc.*, 329 F.2d 684 (9th Cir. 1964); *Everest & Jenings, Inc. v. E and J Mfg. Co.*, 263 F.2d 254 (9th Cir. 1959), *cert. denied*, 360 U.S. 902 (1959). This is not controverted by the Commission, which acknowledges that it has not appealed the parties' ruling. It is therefore settled that these parties may not be added, and the remaining question becomes whether there is any jurisdiction without them.

The Court must therefore confront the question of indispensability. It is asked to review agreements between the Johnson group and the National Securities group and to declare them fraudulent and illegal—in an action in which the Johnson group is not joined. Put another way, those who bought are to be charged with illegality for their purchase, while those who sold are left untouched. This conflicts altogether with the familiar requirement that parties must be joined where this is required by "equity and good conscience," *Shields v. Barrow*, 58 U.S. (17 How.) 130, 15 L.Ed 158 (1855); *State of Washington v. United States*, 87 F.2d 421 (9th Cir. 1936).

We deal with that section of the law of indispensable parties which may be called the "one end of a contract" cases. In the base situation, A and B make a contract. C wishes to challenge the validity of that contract and sues A.

B is an indispensable party. The basic rule, *Hudson v. Newell,* 172 F.2d 848, 852 (5th Cir. 1949), followed in *Young v. Powell,* 179 F.2d 147, 151-52 (5th Cir. 1950), is "We know of no exception to the rule that an instrument cannot be destroyed totally by a decree unless all parties to it, or their successors in interest, are before the court." Certainly the general rule is that "rescission of a contract, or declaration of its invalidity, as to some of the parties, but not as to others, is not generally permitted." *Ward v. Deavers,* 203 F.2d 72, 75 (D.C. Cir. 1953). See the closely related case of *Rader v. Manufacturers Casualty Ins. Co.,* 242 F.2d 419, 428 (2d Cir. 1957); and see *Halpern v. Pennsylvania Ry.,* 189 F. Supp. 494, 498 (E.D.N.Y. 1960); *Stenhouse v. Jacobson,* 193 F.Supp. 694, 696 (N.D. Cal. 1961); and for the problem of enforcement of a disputed contract, *Kleinschmidt v. Kleinschmidt Lab.,* 89 F.Supp. 869 (N.D. Ill. 1950). The matter is closely analogous to *Sawyer v. Pioneer Mill Co.,* 300 F.2d 200, 202 (9th Cir. 1962), a suit originally brought to enjoin use of proxies at a merger meeting. The proxies were used, and the merger voted, whereupon plaintiff sought to amend to demand rescission of the merger. This Court, in holding the case moot, made observations highly in point in this case:

> "The idea of a rescission of the merger is obviously an afterthought of appellant or her counsel. American, the other party to the merger, was not named as a defendant, nor did appellant ask leave to join it. Obviously, it was a necessary party in any attempt to prevent the merger, and it is difficult to believe that its omission was inadvertent. In short, since the purpose was to prevent the meeting, or the use of the proxies at the meeting, since both of those things have happened, and since the present action is not an appropriate vehicle for an attack upon the merger, the action has become moot."

Interstate Commerce Commission v. Blue Diamond Prod. Co., 192 F.2d 43 (8th Cir. 1951), is very close to the instant case. The government sought to enjoin defendant shipper from causing certain motor carriers to haul for it. The injunction, if granted, would keep the defendant from honoring contracts with those carriers on the ground that the contracts were illegal. *Held*, not merely the shipper who was purchasing the service, but also the carrier who was selling it, must be joined in the suit. On the ground that the matter could not be determined without affecting the interest of the absent parties or leaving the interest of those before the court "in a situation that might be embarrassing and inconsistent with equity." the court said, 192 F.2d at 47:

> "These parties have such an interest in the controversy that a final decree cannot, we think, be made without affecting that interest, or, as said by the Supreme Court, 'leaving the controversy in such a condition that its final termination may be wholly inconsistent with equity.' An injunction here against the defendant could only be granted on the theory that the various leases and contracts are void. Certainly these parties have a very substantial interest in that question and we conclude that they are indispensable parties."

The matter really is this simple. Whether the trial court was right or wrong in dropping the Johnson group on the original complaint, the SEC saw fit to amend its complaint so as clearly to involve the sellers. It deliberately added very express allegations that the Johnson group was guilty of breach of fiduciary duty, and deliberately recast the prayer for relief to call for an adjudication that the agreements between the Johnson group and these defendants were illegal. The defendants, in the light of the new pleadings, promptly raised the issue of indispensability and the Commission thereupon moved to cure its own error by add-

ing the absent parties. The Johnson group are clearly indispensable parties; they are not here; and that should be an end to the matter.

III. The Trial Court Correctly Held This Action Barred by the McCarran Act.

15 U.S.C. Sec. 1012(b) (The McCarran Act) provides that "no Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance." A.R.S. Sec. 20-731, a part of the comprehensive insurance law of Arizona, expressly regulates mergers or consolidations of insurance companies, giving the Director of Insurance the duty of approving mergers and, in the course of it, requiring him to determine whether mergers are contrary to law or are "inequitable to the stockholders of any domestic insurer involved." The determination of the Director is appealable to the State courts.

In these circumstances, the District Court held:

> "12. The allegations of the Amended and Supplemental Complaint at bar, if taken to be true, are insufficient to warrant issuance of an injunction against future violations of § 10(b) and Rule 10b-5, since the requested relief of invalidation by this Court of the corporate merger, now finally approved by the Arizona Director of Insurance pursuant to A.R.S. § 20-731, would at least 'impair,' if not 'invalidate' or 'supersede,' laws enacted by the State of Arizona 'for the purpose of regulating the business of insurance,' within the meaning of the applicable provisions of the McCarran Act [15 U.S.C. § 1012(b)];" (R. 800)

A. THE McCARRAN ACT BARS FEDERAL SUPERSESSION OF STATE INSURANCE LAWS.

The spirit of the McCarran Act is recognized in the majority opinion in *Securities and Exchange Commission v.*

Variable Annuity Ins. Co., 359 U.S. 65, 79 Sup.Ct. 618, 3 L.Ed 2d 640 (1959), in which Justice Douglas for the Court said:

> "We start with a reluctance to disturb the state regulatory schemes that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements. When the States speak in the field of 'insurance,' they speak with the authority of a long tradition. For the regulation of 'insurance,' though within the ambit of federal power, (*United States v. South-Eastern Underwriters Ass'n,* 322 U.S. 533, 64 S.Ct. 1162, 88 L.Ed 1440), has traditionally been under the control of the States." 359 U.S. at 68-69, 79 Sup. Ct. at 620.

The legislative history is developed in the dissenting opinion in that same case in language which we think a majority would equally accept, see 359 U.S. 65, at 99, as follows:

> "In 1944, this Court removed the supposed constitutional basis for exemption of insurance by holding, in United States v. South-Eastern Underwriters Ass'n, supra, that the business of insurance was subject to federal regulation under the commerce power. Congress was quick to respond. It forthwith enacted the McCarran Act, 59 Stat. 33, 15 U.S.C. §§ 1011-1015, 15 U.S.C.A. §§ 1011-1015, which on its face demonstrates the purpose 'broadly to give support to the existing and future state systems for regulating and taxing the business of insurance.' Prudential Insurance Co. v. Benjamin, supra, 328 U.S. at page 429, 66 S.Ct. at page 1155, and 'to assure that existing state power to regulate insurance would continue.' Wilburn Board Co. v. Fireman's Fund Ins. Co., supra, 348 U.S. at page 319, 75 S.Ct. at page 373. Thus rather than encouraging Congress to enter the field of insurance, the South-Eastern decision spurred reiteration of its undeviating policy of abstention."

In the case of *North Little Rock Transp. Co. v. Casualty Reciprocal Exch.*, 181 F.2d 174 (8th Cir. 1950), an Arkansas statute authorized the licensing of rating bureaus and provided for the establishment by them of casualty insurance rates to be charged by their members and subscribers. The plaintiff in this case, a taxicab company, sought relief from its insurance rate by an action brought under the Sherman Anti-Trust Act. The defendants denied that they had violated the Sherman Act and asserted that the conduct of which the plaintiff complained was regulated by the laws of Arkansas and under the McCarran Act could not be reached by the Sherman Act. The Court of Appeals held that unless the Arkansas Supreme Court ruled its statute unconstitutional, the federal courts were required to give credence to the Arkansas statute rather than the Sherman Act. Said the court:

> "The purpose of the McCarran Act was to permit the States to continue the regulation of the business of insurance, unhampered, to the extent provided by the Act, by feredal legislation relating to interstate commerce." *Id.* at 176.

In the case of *California League of Independent Ins. Producers v. Aetna Casualty, et al.*, 175 F.Supp. 857 (N.D. Cal. 1959), a California statute authorized cooperation between insurers for rate making and other related matters. Pursuant to that statute, the major insurance companies in California, in setting their rates, agreed to decrease the rate of commission paid to insurance agents. The insurance agents through their organization sued for treble damages under the Sherman Act. The court ruled that California had regulated the business of insurance within the meaning of the McCarran Act, and that by compliance with the McCarran Act, had deprived the Sherman Act of any validity in that area. Said the court:

> "This court is of the opinion that a State regulates the business of insurance within the meaning of § 1012 (b) when a State statute generally proscribes (*F.T.C. v. National Cas. Co.,* 1958, 357 US 560, 78 S.Ct. 1260, 2 L.Ed.2d 1540) or permits or authorizes certain conduct on the part of the insurance companies. In *F.T.C. v. National Cas. Co.,* supra, the Court held that there was State regulation within the meaning of Sec. 1012 (b) when a State act *generally* prohibited 'certain standards of conduct.' 357 U.S. at page 564, 78 S.Ct. at page 1262. From the above case it would seem to follow that if a State has generally authorized or permitted certain standards of conduct, it is regulating the business of insurance under the McCarran Act." *Id.* at 860.

In the case of *Zachman v. Erwin,* 186 F.Supp. 691 (S.D. Texas 1960), plaintiffs brought an action for rescission of the purchase of securities of an insurance business under the Securities Act of 1933. The court held the McCarran Act applicable to an action under the Securities Act, but held that in this particular case there was no Texas statute which could be invalidated. The case is important, however, because the court said:

> "That statute does not preclude application of the Securities Act to the insurance business since there is no indication that it invalidates, impairs, or supersedes any law of the State of Texas regulating the insurance business. An examination of the Insurance Code of Texas reveals no special remedy for purchasers against persons who have defrauded them in the sale of insurance company securities." *Id.* at 694.

By implication, of course, if there had been a Texas statute being superseded by the application of the Securities Act, the decision of the Court obviously would have been the opposite. In our case, as is developed below, we

learly have Arizona statutes authorizing action by the Director of Insurance which would be superseded and invalidated and impaired by the application of the relevant statutes.

In the case of *Federal Trade Commission v. National Casualty Co.,* 357 U.S. 560, 78 Sup.Ct. 1260, 2 L.Ed.2d 1540 1958), the Supreme Court held that with respect to advertising which was prepared and shipped in bulk to insurance company agents, for local distribution, regulation of advertising was within the means of regulation of the various states, and that the Federal Trade Commission had no authority. The Federal Trade Commission argued that, even conceding the validity of the McCarran Act as limiting the jurisdiction of the Federal Trade Commission, State regulation of these practices was not sufficient to bring the McCarran Act into operation. Said the Court:

> "Petitioner does not argue that the statutory provisions here under review were mere pretense. Rather, it urges that a general prohibition designed to guarantee certain standards of conduct is too 'inchoate' to be 'regulation' until that prohibition has been crystallized into 'administrative elaboration of these standards and application in individual cases.' However, assuming that there is some difference in the McCarran-Ferguson Act between 'legislation' and 'regulation,' nothing in the language of that Act or within its legislative history supports the distinctions drawn by petitioner." 357 U.S. at 564, 78 Sup.Ct. at 1262.

In the instant case, the Commission argues that the "sale of stock of insurance companies" is not exempted from Federal control by the McCarran Act. It relies on two cases, *Securities and Exchange Commission v. American Founders Life Ins. Co.* (Civ. No. 6021, D. Colo. 1958), and *United States v. Meade,* 179 F.Supp. 868 (S.D. Ind. 1960). The former case apparently is unreported, and we cannot com-

ment as to it. The *Meade* case held that the particular company was not engaged in any relevant fashion in the "business of insurance" at all. See 179 F.Supp. at 876.

But this talk drags a red herring into the case. We are not dealing with the sale of stock or anything else which is tangential or remote from the central function of insurance regulation. In the instant case the ultimate question to be determined by someone is the absolute bedrock question of the existence of an insurance company. Here these two Arizona insurance companies could merge and become one Arizona insurance company or they could not. The determination of this question is at the very heart of the state regulatory function.

As the Fourth Circuit has recently said, "Unless a Federal statute is made specifically applicable to the insurance business, it shall not 'invalidate, impair or supersede' any State insurance law." *Allstate Ins. Co. v. Lanier,* 361 F.2d 870 (4th Cir. 1966). The guiding principle is that "Where there is an applicable state statute, the federal Legislation does not apply." *Transnational Ins. Co. v. Rosenlund,* 261 F.Supp. 12, 26 (D. Ore. 1966).

B. THE ATTEMPTED APPLICATION OF FEDERAL LAW WOULD SUPERSEDE STATE LAW.

The McCarran Act may permit supplemental or ancillary or additional Federal regulation which somehow relates to insurance; an illustration is *United States v. Sylvanus,* 192 F.2d 96 (7th Cir. 1961), a mail fraud case. What it prohibits is federal acts which "invalidate, impair or supersede" State laws regulating insurance. This is precisely the instant case.

1. The underlying transaction occurred on April 27, 1964. According to paragraph 13 of the complaint (R. 430), "as a further incident of said scheme and plan," a manage-

nent agreement was entered into on that date between Producers Life and National Securities by which National Securities "assumed full and complete management of the business and affairs of Producers Life."

This management agreement was expressly approved in writing by the Director of Insurance of Arizona after full consideration, in accordance with A.R.S. Sec. 20-727. The Arizona statute expressly provides that the director should disapprove of any such contract if he finds that it:

> "1. Subjects the insurer to excessive charges.
>
> "2. Is to extend for an unreasonable length of time.
>
> "3. Does not contain fair and adequate standards of performance.
>
> "4. Contains other inequitable provisions or provisions which impair the proper interests of stockholders or members of the insurer."

The Arizona Director of Insurance presumably found that the management agreement was fair in its charges, was not too long in its period of operation, was fair and adequate in its standards of performance, and contained no other inequitable provisions which would impair the proper interests of stockholders of Producers. We thus find the Commission asking this court to accept as an "incident of said scheme and plan" the precise matter which has been found to be wholly appropriate under Arizona law by the Arizona authority charged with this duty.

2. The complaint complains that the shares of Producers Life which were acquired by National Securities were transferred to National Life. This investment of over a million dollars by National Life was also expressly approved, in writing, by the Director of Insurance as required by A.R.S. Secs. 20-535 and 536.

3. This action purports to be brought under Commission Rule 10b-5, the first point of which makes it improper "to employ any device, scheme, or artifice to defraud." The precise "artifice" being enjoined is a merger. Yet A.R.S. Sec. 20-731 B. expressly provides that any merger must be submitted to the Director of Insurance to determine whether it is "contrary to law" or "inequitable to the stockholders of any domestic insurer involved." In addition there are other criteria but this is enough—the Commission complains that there is a plan resulting from a breach of fiduciary duty which is unfair to the other shareholders of Producers. This *exact* matter must come on for a decision by the Arizona Director of Insurance before the merger can become final. It would be an impossibility to supersede his function more completely than does this injunction—that function is totally obliterated.

4. Rule 10b-5 makes it illegal "to make any untrue statement of a material fact or to omit to state any material fact necessary" to deal fairly with the subject matter. A.R.S. Sec. 20-447 expressly prohibits the making or distribution of false statements on finances, again the general substance of precisely what is being complained of by the Commission.

5. The provision just noted is part of Article 6 of the Arizona Insurance Code which is headed "Unfair Practices and Frauds." This article begins with A.R.S. Sec. 20-441 which declares Arizona's express and precise purpose of meeting the responsibilities of the McCarran Act by providing state regulation for those matters which should be thus regulated. A.R.S. Sec. 20-441 is as follows:

> "Among the purposes of this article is the regulation of trade practices in the business of insurance in accordance with the intent of Congress as expressed in the Act of Congress of March 9, 1945, 59 Stat. 33, by

> defining, or providing for the determination of, all such practices in this state which constitute unfair methods of competition or unfair or deceptive acts or practices and by prohibiting the trade practices so defined or determined."

Nor is this merely a pious prayer. As to the vital matter of the merger, the duty of approval or disapproval lies squarely on the Director of Insurance as has been noted. A.R.S. Sec. 20-142 gives him full investigative authority. The very remedy of injunction itself is expressly provided by A.R.S. Sec. 20-152 "if the Director has cause to believe that any person is violating or is about to violate a provision of this title."*

IV. The Merger Is Not a "Purchase or Sale" for Purposes of Rule 10b-5.

The transaction which the SEC originally sought to enjoin and which it now seeks to undo is the merger of two insurance companies, Producers and National Life. The complaint alleges fraud and the answer denies anything of the sort, but whichever party is right, unless a statutory merger is a "purchase or sale" within the meaning of Rule 10b-5, that section has no application to the instant case at all.

The question has been decided by this Court in favor of the position of appellees in *National Supply Co. v. Leland Stanford, Jr. University,* 134 F.2d 689 (9th Cir. 1943), *cert. denied,* 320 U.S. 773 (1943). The SEC has advised this Court in this case that it "will seek to have this Court over-

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*Whether these matters will be within the scope of the Commission's jurisdiction under the 1964 amendments to the 1934 Act is a problem for the future; Section 12(g)(1)(G), 15 U.S.C. Sec. 78*l*(g)(1)(G) makes this depend upon whether the states have special legislation.

rule or severely delimit a determination previously made by it" in the *National Supply Company* case.*

Judge Mathes did not squarely decide this matter since there were abundant other grounds for his conclusion. The relevant language of his order on this point is in the note.†

A. A STATUTORY MERGER IN ARIZONA IS IN FACT NOT A PURCHASE OR SALE.

We begin with precisely what it was that the parties were doing. The consolidation or merger plan presented for the vote for which proxies were solicited, is at R. 79-87. At that time, Producers had about 881,000 shares of stock outstanding and National Life had about 1,018,000 outstanding, each with a par value of one dollar. "The principal purpose of this Agreement is to provide for the merger of National Life into Producers, which will continue as the surviving corporation, governed by the laws of the State of Arizona." (R. 80) The parties agreed to submit their plan to the

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*In the Commission's opening brief on the merits, the "no sale" matter is discussed, pp. 22-28. The passage concerning the request to "overrule or severely limit" the earlier case is from page 2 of the Affidavit of Newman in support of the motion of the Commission for enlargement of time, dated December 29, 1966.

†"Even if it be assumed that § 10(b) would otherwise be applicable to proxy solicitations [but see *Borak v. J. I. Case Co.,* unreported in the District Court, 317 F.2d 838, 846-847 (7th Cir. 1963), aff'd on other grounds, *sub nom. J. I. Case Co. v. Borak,* 377 U.S. 426 (1964)], and that a shareholder-approved corporate consolidation and reorganization is a "purchase or sale" of securities within the meaning of § 10(b) and Rule 10b-5 [*compare H. L. Green Co. v. Childree,* 185 F.Supp. 95 (S.D.N.Y. 1960), *and Voege v. American Sumatra Tobacco Corp.,* CCH Federal Security Law Reports ¶ 91,571 (D.Dela. 1965), *with National Supply Co. v. Leland Stanford, Jr. University,* 134 F.2d 689 (9th Cir. 1943), *and Sawyer v. Pioneer Mill Co.,* 190 F.Supp. 21 (D.Hawaii 1960), remanded 300 F.2d 200 (9th Cir. 1962), cert. den., 371 U.S. 814 (1962)], there still remains the question of whether the McCarran Act (59 Stat. 33, 15 U.S.C. §§ 1011-1015) does not preclude the application in this case of § 10(b), as implemented by Rule 10b-5;"

Director of Insurance and to the stockholders (R. 80). National Producers, as the surviving corporation, was to have an authorized capitalization of $2,500,000 divided into 5,000,000 shares of common capital stock.

We next reach the actual matter of stock transfer. Paragraph 12 of the Agreement covers the "manner of converting the shares and assets of National Life." Producers was to "issue and deliver to the stockholders of National Life" a share of Producers stock for each share of National Life stock. If a National Life stockholder for whatever reason simply kept his National Life stock, the same paragraph provided that he should be regarded "for all corporate and legal purposes, to be the owner of that number of National Producers shares." (R. 81).

That is it. Prior to the merger, each shareholder had a certain number of shares of stock of Producers and after it, he had the equivalent in shares of National Producers. Before the merger, each shareholder of National Life had National Life shares, and after the merger, he had the same number of National Producers Life shares.*

The plan and the actuality were closely guided by the Arizona Code. A.R.S. Sec. 10-341, *et seq.*, covers mergers. Two corporations "may be consolidated"; they do so by making an agreement which covers how to convert the shares and assets of the retiring corporation. Notices are required and then "the agreement of the Boards of Directors to consolidate" is submitted to the shareholders. The vote, for which solicitation of proxies is expressly authorized, is whether to adopt or reject the consolidation plan. The

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*To avoid converting the National Life shares into fractional shares by a fractional merger ratio, all Producers shareholders were given a 20 percent stock dividend. See paragraph 16 of the Consolidation Agreement, R. 79, 82.

merger is legally effective upon the ratification of the agreement by each of the corporations, and there is no requirement that the shares even be turned in or replaced. Dissenting stockholders may elect to be paid in cash for their shares. The Insurance Code adds to these requirements the approval by the Director of Insurance.

The point of this recital is that the transaction is a straight conversion. There is no purchase or sale about it. A consolidation agreement either is or is not approved by the shareholders. If it is approved, then the National Life shareholders may, if they wish, turn in their old certificates and get new certificates, but no one buys, no one sells. If they do not wish to turn the old certificates in, they need not do so—the operative legal effect is all the same by virtue of simple conversion occurring from the act of approval of the agreement itself. The shareholder has the option, if he wishes, of getting a new certificate to represent the stock he actually holds. Any shareholder at any given point has two separable interests, the one his actual interest or ownership of his fraction of the corporation, and the other his piece of paper which is evidence of that ownership. The shareholder's actual interest is changed by the vote on the consolidation agreement and the resultant filings and approvals, and this without the faintest semblance of anyone selling or purchasing anything. All that happens thereafter is the exchange of pieces of paper recognizing this interest.

B. AS A MATTER OF LAW, A STATUTORY MERGER IS NOT A "PURCHASE OR SALE."

The instant transaction is a pure statutory merger and is not a "purchase or sale" at all.

1. We are dealing with what is called the "no sale doctrine" and the interpretation of the 1934 Act in this re-

spect begins with the 1933 Act. Section 17 of the 1933 Act, 15 U.S.C. Sec. 77q, in various ways is directed at frauds in the sale of securities. The term "sale" is used also in Section 5 of the 1933 Act, 15 U.S.C. Sec. 77f, and in turn is defined in Commission Rule 133. It is thus Rule 133 and its antecedents which is the origin of the "no sale doctrine."

Rule 133 expressly excludes from the definition of "sale" a transaction where, in accordance with state law, a plan or agreement for a statutory merger or consolidation (a) is submitted to the vote of the stockholders; (b) where such a merger can be adopted only upon the vote of some established majority of the outstanding stock; and (c) where such a vote is binding on all stockholders except to the extent that dissenters may be entitled to receive the appraised or fair value of their holdings. Rule 133 could not cover more precisely an Arizona statutory merger—every item in the rule is also in the Code.

It follows that if Rule 133 as applied to the 1933 Act is equally applicable to Section 10 of the 1934 Act, then there could not conceivably be jurisdiction in the instant case because there is "no sale."

The Commission has been on both sides of this question in this Circuit:

(a) In *National Supply Co. v. Leland Stanford, Jr. University*, 134 F.2d 689 (9th Cir.), *cert. denied*, 320 U.S. 773 (1943), a stockholder brought an action under Sec. 12 of the 1933 Act for rescission in connection with stock issued as a result of a statutory merger or consolidation under Delaware law. At this time, Rule 133 was not in effect but an analogous antecedent rule was. The SEC brief in that case we deposited by photocopy with the District Court clerk; but its essential flavor will be shown by the following passages:

"But consolidations such as the one involved in this case and mergers under related provisions of law are not comparable to the various exchange situations just discussed. In such consolidations and mergers the alteration of the stockholder's security occurs not because he consents to an exchange, but because the corporation by authorized corporate action converts his security from one form to another. That is to say (as indicated by the Note to Rule 5), there is no sale where (1) the vote of the stockholders is effective (subject to directors' action and other statutory requirements) as corporate action and (2) this action binds all stockholders, assenters, dissenters, and non-voters alike (subject only to appraisal rights of dissenters). The essence of the Commission's construction, as expressed in the Note, is that in such cases a proposed corporate act is submitted to stockholders to be accepted or rejected by them as a class, in their capacity as members of the corporate body . . .

"A few examples will illustrate the difference between submission of a proposal for corporate action and an offer of exchange to stockholders as individuals:

(1) A proposal for merger or consolidation is submitted to the vote of the directors of a corporation before being submitted to the stockholders. Although the merger or consolidation, if consummated, will result in the directors getting different securities for those they held before the vote, we think it obvious that the submission of the proposal to them is not a "sale," because they act in their capacities as functionaries of the corporation, not as securityholders. The fact that they may hold securities which will be changed by the corporate action is immaterial, since the submission to them is not for the purpose of choice as individuals but as a step in the process of corporate action. We believe that subsequent submission of the same plan to those same directors as stockholders no more involves a sale than does the submission to them as directors. Both

directors' vote and stockholders' vote are necessary parts of the process of corporate action."

This Circuit Court of Appeals, noticing this brief, said:

". . . The Securities and Exchange Commission has filed an exclusive brief amicus curiae indicative of its view that the consolidation did not involve a 'sale' of securities, or an exchange amounting to a sale, hence the civil liability provisions of the Act have no application. Without going into the matter, we may say that we are in accord with the views of the Commission." 134 F.2d at 694.

(b) On the other hand the Commission took what seems to us to be the opposite point of view in *Sawyer v. Pioneer Mill Co., Ltd.*, 190 F.Supp. 21 (D. Hawaii 1960), *appeal dismissed for mootness*, 300 F.2d 200 (9th Cir. 1961), *cert. denied*, 371 U.S. 814 (1962). In *Sawyer*, an individual stockholder brought an action to enjoin a corporation from holding special stockholder meetings and from using certain proxy materials in effecting a corporate reorganization. In short, the private shareholder was seeking to enjoin essentially the same thing that the Commission is seeking to enjoin in the instant case, and it was doing so squarely on section 10(b) of the 1934 Act, the very same Act which is here involved. The Commission there argued that the "no sale rule" did not apply to the 1934 Act.

The District Court Judge, C. Nils Tavares, rejected this point of view and held flatly that there is no jurisdiction under Section 10(b) as to statutory mergers. The following findings of fact and conclusions of law are pertinent (190 F.Supp. at 23):

"8. That the solicitation of proxies by the defendants was for the purpose of effecting a corporate reorganization in accordance with the provisions of the Corporation Law of the State of Hawaii permitted by

Chapter 173, Revised Laws of Hawaii 1955, as amended, and not for the purpose of effecting a purchase or sale of any security.

"Conclusions of Law

* * * * * * *

"2. That the Court has no jurisdiction over the subject matter of this suit arising under the provisions of Section 10 of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78j as implemented by Rule X-10B-5 (17 C.F.R. § 240.10b-5)." *Id.* at 23.

2. The definitions of sale in the 1933 and the 1934 Acts were for all practical purposes identical.* We respectfully submit that on authority of the *Stanford* and *Sawyer* cases, we have a statutory merger, not a purchase or a sale, as those terms are used in Sec. 10(b). We cannot in this respect improve upon the argument made by the Commission in the *Stanford* case and we incorporate it by reference.

3. The weight of the cases in other circuits, we submit, supports the Ninth Circuit position. The SEC deals with this point at pages 22-28 of its opening brief. No case cited in its text supports their position even remotely; indeed, none is tendered as doing so. The few cases cited go to the rhetoric of the wholesome purposes of the SEC, but not one of them even purports to zero in on the question of the scope of Rule 10b-5. The matter is thus reserved to footnote 22, p. 28, of the Commission's brief, which is the compilation of relevant cases. They are as follows:

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*The principle is covered by the observation of Judge Bryan in *Barnett v. Anaconda Co.*, 238 F.Supp. 766, 774 (S.D.N.Y. 1965).

> "For all practical purposes both 17(a) [of the 1933 Act] and 10(b) [of the 1934 Act] with its implementing rule cover the same ground with one exception. Section 17(a) deals only with fraudulent practices 'in the offer or sale of any securities.' Section 10(b) through its implementing Rule 10b-5 deals with such practices in 'connection with the purchase or sale of any security.'" *Id.* at 774.

a. *Dasho v. The Susquehanna Corporation* (N.D. Ill., No. 65 C 1757, April 15, 1966, *rehearing denied,* June 28, 1966), *appeal pending,* (7th Cir.). The District Judge in this case held precisely as we contend here, that a statutory merger is not within the scope of this Rule at all. He said in his opinion of April 15, 1966:

> "We must conclude that the merger as stated in the complaint is not actionable under the fraudulent sale provisions of the Securities Acts. A statutory merger of the type with which we are concerned results in the automatic *involuntary* conversion of one type of security into another. That is, Susquehanna stock was not 'sold' for shares of Gypsum, but, rather, upon merger, the corporation converted shareholders' security from one form to another. This distinction was clearly upheld by the Ninth Circuit Court of Appeals in *National Supply Co. v. Leland Stanford Jr., University,* (9th Cir., 1943) 134 F.2d 689, at p. 694:
>
> " 'The Securities and Exchange Commission has filed an exhaustive brief *amicus curiae* indicative of its view that the consolidation did not involve a "sale" of securities, or an exchange amounting to a sale, hence the civil liability provisions of the Act have no application. Without going into the matter, we may say that we are in accord with the views of the Commission.' "

On motion for rehearing, the court enlarged its views. After discussing cases cited by the plaintiff purportedly opposed to his original opinion, the judge said:

> "In contrast, we find significant authority attesting to the correctness of our decision in the cases cited by defendants and referred to in our April 15 opinion.
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> "In *National Supply Co. v. Leland Stanford Jr. Univ.,* (9th Cir., 1943) 134 F.2d 689, the Court held that no cause of action existed under Section 12(2) of the 1933 Act because the statutory 'consolidation did not involve a sale of securities or an exchange amount-

ing to a sale . . . ." While plaintiffs assert that the *Leland Stanford* case is limited, and that the definition of sale involved therein does not apply to Rule 10(b) 5 actions, we cannot agree. We must assume that the Court in the above case accepted the then official position of the S.E.C., as stated in its *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees,* Part vii, p. 249, f.n. 172 (1938), which report was transmitted over the signature of Mr. Justice Douglas, then Chairman of the S.E.C., and was prepared by named members of the Commission staff, including Mr. Justice Fortas. That report clearly stated, in part:

"'. . . it is essential to a "sale" under Section 2(3) [the definition provisions applying to the entire Act] that the prospective purchaser have the right individually and voluntarily to elect whether or not to purchase. In the case of the typical consolidation, merger, or sale of assets, this essential volition on the part of the individual shareholders is absent.'

"While it is apparent from the *amicus curiae* briefs submitted in the *Kuhn* case, referred to above, that the S.E.C., as an advocate, has changed its views, it is noteworthy that the Ninth Circuit Court of Appeals accepted the logic of its initial opinion, and that Congress, while aware of this attitude, and of the *Leland Stanford* decision, has not acted to alter the language of the section involved although it has had 23 years to do so, and, indeed, has enacted many other amendments during that period. While the S.E.C. may wish now to propose a new approach, it does so as an advocate alone, and we are certainly not bound to accept their arguments when we conclude that they are opposed to the logic of the only existing Court decisions in point, and to the intention of Congress as manifested by its inaction in this area. See *Safeway Stores v.*

Bowles, (U.S. Emergency Ct. of App., 1944), 145 F.2d 836, cert. den. 324 U.S. 847.

"In addition, we cannot accept plaintiffs' view that the Court in *Leland Stanford* merely adopted the 'no-sale' theory codified by the S.E.C. in Rule 133. Plaintiffs argue that under said rule, the issuance of stock upon a merger will not be considered a sale for registration purposes under Section 5, and that inasmuch as the rule specifically states that it does not apply to other sections of the Act, defendants cannot seek an exemption under Section 10(b). It is abundantly clear that the Ninth Circuit did not rely on Rule 133, as contended, inasmuch as *Leland Stanford* dealt with Section 12 only, and not Section 5."

This case is on appeal in the Seventh Circuit.

b. *Vine v. Beneficial Finance Co., Inc.,* 252 F.Supp. 212 (S.D.N.Y., 1966), *appeal pending,* (2d Cir.). *Vine* is conceded by the Commission to be contrary to its own position, but not quite so clearly as *Dasho.* Its holding is that a stockholder allegedly defrauded as a result of a New York short form merger is not a seller of securities within the ambit of the Securities Exchange Act, Section 10(b) and Rule 10b-5, since he did not accept an offer to sell his shares which was alleged as a preliminary step in the fraudulent scheme. Noting that the New York statute provides for the right to a fair appraisal and preserves the right to challenge the legality of the merger, the District Judge at page 215 said:

". . . no reason here exists for attempting to extend the purview of Section 10(b) of the Securities Exchange Act beyond the decisions of this circuit or in seeking to rationalize 'in connection with the purchase or sale of any security' to the situation here presented."

In *Vine,* appeal is also pending.

c. *Simon v. New Haven Board & Carton Co.,* 250 F.Supp. 297 (D. Conn. 1966). This is listed by the Commission as a decision which agrees with its position here. We don't know why. In *Simon,* the New Haven Railroad apparently (for the facts are not clear) issued stock pursuant to some authorization and used it to acquire another company which was merged with it. The District Court decision holds "that the corporate issuance of stock is a 'sale' within the meaning of the rule," 250 F.Supp. at 299. In the *Simon* case, the very fraud charged was that "the value of the stock issued" was "in excess of the consideration received," 250 F.Supp. at 298. In other words, in that case there was an actual bargain and sale for consideration; this is not in the statutory sense a merger at all.

d. *Voege v. American Sumatra Tobacco Corp.,* 241 F.Supp. 369 (D.Del. 1965). This case, too, is not in the real sense a merger. Here the plaintiff was called upon actually to sell her stock at a certain number of dollars a share. This was as a result of a merger but was a perfectly real sale, and this is the precise basis of the decision.

e. *Barnett v. Anaconda Co.,* 238 F.Supp. 766 (S.D.N.Y. 1965). This case is not a merger at all; it was a sale of assets for stock.

f. This leaves the very specific decision in *Sawyer v. Pioneer Mill Co. Ltd.,* cited and discussed earlier. This direct holding of a Ninth Circuit District Court is acknowledged by the Commission to be flatly against it.

Rule 10b-5 does not apply to this case because a statutory merger under the law of Arizona is not either in fact or in law a purchase or sale. Certainly, in this Circuit this kind of transaction has been recognized as not a purchase or sale since the *National Supply Company* decision in

1943. That decision, which the Commission now asks this Court to overrule, was reached at the behest and urging of the Commission itself 24 years ago. We can only say that this Court and the Commission were then right. No Circuit has disagreed. The only District Court cases which are truly squarely in point follow the principles of this Circuit's decision. There is no new light which calls for an overruling of the earlier decision. It should not be overruled.

V. Rule 10b-5 Does Not Deal with Proxy Solicitations.

The Securities Exchange Act of 1934 gives the Commission a mighty arsenal of weapons, and not all of them are in any one section or in any one rule. Rule 10b-5 deals with certain frauds in the purchase and sale of securities. The proxy section and the proxy rule are altogether different. It is Section 14 of the Act and Rule 14a-9 which deal with proxy solicitations. Section 14 of the Act, 15 U.S.C. Sec. 78n as it appeared prior to the 1964 amendments made it illegal in violation of the rules of the Commission to solicit proxies "in respect of any security . . . registered on any national securities exchange." These insurance companies were not registered on a national exchange, and therefore the Commission could not and did not attempt to assert jurisdiction of their proxy solicitations under the proxy rules.

Section 14 was extensively amended in 1964, 78 Stat. 569. The critical portion of the amendment is Section 12(g) of the Act, 15 U.S.C. Sec. 78*l*(g), extending the scope of the registration requirements to companies like these whose sales are over-the-counter. Under the previous law, Section 14 applied only to registered securities and excluded the over-the-counter variety. The amendment did not take

effect until 1966, so the companies of the sort here involved would not, in any circumstance, be subject to the Act until that time. But in addition there was an exemption for securities issued by insurance companies which were themselves subject to State regulations. These companies are in fact now subject to State regulations and therefore to this day they are not subject to Section 14 to this day.*

In these circumstances, the trial court recognized appellees' contention as made below. In the trial court, appellees contended as follows:

> "In the preceding section, we have argued that under Sec. 10(b), the statute does not reach statutory mergers. In this portion of the argument, we move to a new, alternative, but related position. That is that even if Sec. 10(b) did apply to mergers (which as we have argued it does not) it does not apply to proxy solicitations." (R. 216)

This point was developed more fully at R. 217-218. We again quote from our District Court brief:

> "In other words, the Commission is seeking to get a one year jump on the recent statute by doing now precisely what it will be authorized to do sometime after the middle of 1966 under the new Act. It seeks to do so by applying Sec. 10(b) to do the work of Sec. 14. We contend that Sec. 10(b) cannot be used for this purpose. The precise point was so decided by the Federal District Court in *Borak v. J. I. Case Company,* unreported in the District Court, 317 F.2d 838 (7th Cir. 1963), aff'd, *sub nom., J. I. Case Co. v. Borak,* 377 U.S. 426, 84 Sup. Ct. 1555 (1964). In *Borak,* a proxy solicitation had been made by allegedly false

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*The present status of the matter depends upon events which occurred subsequent to the proceedings of the District Court and this therefore must be taken only as an avowal rather than as a record reference.

and misleading means. Plaintiffs sued in a private action under both Sec. 10(b) (as the Commission seeks to do here) and under Sec. 14 (as the Commission does not seek to do here). Judge Tehan whose unreported opinion we deposit with the Clerk, expressly rejected the 10(b) approach to the problem. He said:

> '. . . The facts which plaintiff alleges as constituting a violation of § 10b, that is, the soliciting of proxies by means of a proxy statement containing false and misleading statements and omissions of fact, constitutes, if true, a violation of § 14a and not of § 10b. It is § 14a and not § 10b which protects "the stockholders" right to full and fair disclosure in corporate elections by proxy.'"

The treatment of the point in the higher courts is also considered in our District Court brief at R. 218.

We have taken the unusual step of quoting the District Court brief because it illuminates the ruling of Judge Mathes and it makes the more remarkable the treatment of this same matter by the Commission in this Court. In the light of the foregoing argument, Judge Mathes said:

> "The acts complained of would fall within the prohibitions of the proxy-solicitation-anti-fraud provision of § 14 of the 1934 Act [15 U.S.C. § 78(n)], as implemented by Rule 14a-9 [17 CFR 240.14a-9], but for the fact that the stock of the insurance companies involved has never been registered on any national securities exchange;
>
> "Not until sometime during 1966 will the coverage of § 14 be extended, by virtue of the act of August 20, 1964 [78 Stat. 569], to any corporation similarly situated to the insurance companies involved in this action; and then only if not exempted by new § 12(g)(2)(G) of the 1934 Act [15 U.S.C. § 78(l)(g)(2)(G)] which excludes "any security issued by an insurance

> company" provided the insurance company is subject to certain defined State regulation; . . .
>
> "Even if it be assumed that § 10(b) would otherwise be applicable to proxy solicitations [but see *Borak v. J. I. Case Co.,* unreported in the District Court, 317 F.2d 838, 846-847 (7th Cir. 1963), *aff'd on other grounds, sub nom. J. I. Case Co., v. Borak,* 377 U.S. 426 (1964);"

. . . going on to other grounds.

1. If the Findings and Conclusions of Judge Mathes may be regarded as an adjudication in our favor on the Section 14 argument, then the Commission has not met it at all. In its points on appeal, the subject is not touched (R. 820-21), and in its brief, it is not taken up. Appellees contend that this is an independent ground for the result, not challenged on appeal, and that on this ground apart from any other, the decision of the court should be affirmed or the appeal of the Commission should be dismissed.

2. Quite apart from the purely technical question just mentioned, we submit that Judge Tehan was right on the merits. As he said, "It is § 14a and not 10b which protects 'the stockholders' right to full and fair disclosure in corporate elections by proxy." See also *Barnett v. Anaconda,* 238 F.Supp. 766, 776 (S.D.N.Y. 1965), where the court stated:

> "Moreover, in any event, there is no good reason why a claim based for all practical purposes solely on allegedly deceptive proxy material which is fatally defective for lack of causal connection under § 14(a) should be held to be good under § 10(b) and Rule 10b-5 or § 17(a). Section 14(a) is specifically designed to deal with deceptive proxy material and consequences flowing therefrom. There is nothing here to justify any contention that § 10(b) and Rule 10b-5 and

> § 17(a) provide enlarged or different remedies for what are merely violations of § 14(a)."

The 1964 amendments are expressly based on a special study by the Commission, as to which the relevant portion is House Doc. No. 95, pt. 3, pp. 40-41, 88th Cong. 1st Sess., in which the Commission dealt, among other things, with the need of coverage of insurance companies. In its discussion of proxy materials as they relate to insurance companies, the Commission expressly asserted that the proxy materials used in connection with such companies were inadequate by Commission standards. The Commission said:

> "In 15 instances, matters other than election of directors are to be voted on—*mergers*, options, retirement plans, etc.; there was not one solicitation which contained information approaching that required by the Commission proxy requirements." (Emphasis added.)

Again, in the statement made by SEC Chairman, William L. Cary, before the Senate Committee on Banking and Currency, various statements of the Commission itself were presented. One of these, a statement by the Commission staff relating to Sec. 14, expressly cited mergers as illustrative of the need for broadening the proxy controls; see *Federal Securities Law Reports*, CCH, No. 905, pt. 1, June 20, 1963, p. 89.

Why did the Commission tell the Congress that it needed to amend the Exchange Act to make the proxy rules applicable to mergers of over-the-counter companies if it already had that power under Section 10(b)? If, as it now contends, it has power under this subject matter under both sections, surely it was disingenuous not to have acknowledged it to the Congressional Committee.

We submit that Judge Tehan was absolutely right when he held that proxy solicitation is not a 10(b) matter.

VI. The Trial Court Committed No Error in Regard to the Purchase of Treasury Stock.

This case was presented to the trial court entirely in terms of the 1965 merger and the proxy solicitations in connection with it. But the SEC as an afterthought now contends that somehow the original purchase of treasury stock by National Securities from Producers in April, 1964, was a violation of Rule 10b-5. The complaint, R. 428, contains an allegation in connection with the Pound noncompete agreements that the defendants had some undisclosed intention not really to pay for the treasury stock which they purchased, but rather intended somehow to move this back, at least in part, on the seller, Producers.

1. The assignment of error relating to this subject is in the SEC brief, p. 10. Its precise language is as follows:

> "3. *The district court erred to the extent it may have suggested that the fraudulent statements made in connection with* the consolidation of Producers Life and National Life into National Producers and *the fraudulent omissions in the purchase of Producers Life treasury stock* were not 'in connection with the purchase or sale' of securities within the meaning of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder." (Emphasis added.)

This assignment of error itself clearly suggests that the District Court said something about alleged fraudulent omissions in the purchase of the treasury stock. But this is not so. The trial court did not say a word on this subject and suggested nothing at all. The sole express reference of the trial court to the purchase or sale problem refers solely and exclusively to the merger (R. 798)

and the error of "suggestion" which the Commission here charges simply never occurred at all.

This is because this entire point is a plain, unadulterated afterthought on the part of the Commission. It was not merely not "suggested" by the trial court; it was not "suggested" by the SEC either. Pretty clearly, the Commission seeks to rescue a bad situation here with the offer of arguments which it now wishes it had made but never did make in the court below.

This it may not do. All claims must be presented to the trial court and may not be presented for the first time on appeal unless they go to jurisdiction. See *Stephens v. Arrow Lumber Co.*, 354 F.2d 732 (9th Cir. 1966) (New contention regarding nature of contract not considered by appellate court). The rule is based upon sound policy considerations and, barring extraordinary circumstances, will be followed. *Partenweederei, M S Belgrano v. Weigel*, 313 F.2d 423, 425 (9th Cir. 1962), *cert. denied* 373 U.S. 904 (1964). Exceptions to this rule will be made only "to prevent manifest miscarriage of justice." *Thomason v. Klinger*, 349 F.2d 940 (9th Cir. 1965).

2. The SEC position is in any case without merit. The essence of the argument is that it is fraudulent to purchase stock in a company without disclosing an intention later to submit for approval of stockholders of that company a plan of reorganization one provision of which would excuse payment of part of the purchase price of the stock. This, it is asserted, is the fraud of nondisclosure. We are cited to such cases as *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956) and *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965). *Errion*, which seems to us immaterial, holds that Rule 10b-5 applies to fraud in the sale of stock plus the sale of

land; in other words, the mingled nature of the sale does not affect the application of Rule 10b-5. Why it is cited here, we must respectfully acknowledge, we do not know. *List* deals with insider fraud and the duty of corporate insiders to divulge to outsiders secret knowledge of their own concerning the corporation. But there is not even the thinnest kind of an allegation that the National Securities purchasers were "insiders" or had any fiduciary duty to Producers at the time of this purchase.

We have elsewhere pointed out that this was a nonexistent intention on April 27; but we realize that this is a factual matter which is not to be disputed on this motion. Yet the Commission, if it is to have the benefit of the fact that this matter is considered on the pleadings, must also take the liabilities. Paragraph 12 of the amended complaint (R. 430) expressly alleges that in all of the activities complained of (which would include this one) the selling directors were acting in concert with the defendants and in breach of their fiduciary duties. If so, then certainly the Commission cannot be heard to contend that there has been a failure of disclosure since the Commission here expressly alleges full knowledge on the part of the sellers acting as directors of Producers.

There is a larger point—the question of whether the selling directors breached their fiduciary duties by entering into the treasury stock transaction with National Securities. However, even if they did, *O'Neill v. Maytag*, 339 F.2d 764, 768 (2d Cir. 1964), concludes that a breach of general fiduciary duties owed by directors does not come within Rule 10b-5.

> "Our conclusion follows from our view of the purpose of § 10(b): '[T]hat section was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of

> securities rather than at fraudulent mismanagement of corporate affairs.' Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2 Cir.), cert. denied, 343 U.S. 956, 72 S.Ct. 1051, 96 L.Ed. 1356 (1952)."

The court reached its conclusion contrary to the position taken by the Commission in that case and rejected as "broad dictum" language, *McClure v. Borne Chemical Co.,* 292 F.2d 824 (3d Cir. 1961), *cert. denied,* 368 U.S. 939 (1961), which is again relied upon by the Commission in its brief before this Court. In any case, if there has been a violation of Rule 10b-5 by the selling directors, they are no longer parties to the instant action as we have previously pointed out.

VII. The Claimed Remedy Is Not Within the Relief Available to the Commission.

The Commission originally brought this action to enjoin a merger. When this relief was denied and its temporary restraining order to this effect was quashed, the Commission took no further step to bar the merger. It did not, for example, apply to this Court for a stay pending appeal. The Commission, with emphatic insistence by Judge Mathes that this be done, was kept fully advised of the pending review of the matter by the Director of the Arizona Insurance Department in connection with his approval; indeed, the Commission submitted all of the information it had to the Director of the Arizona Insurance Department without, however, becoming a party. Hence, when the Arizona Director approved the merger the Commission was in no position to appeal as it might have done under Arizona law and apparently no other person was dissatisfied with the Director's order of approval, and no appeal was taken.

The question then arises whether the Commission may, after the event, attack the merger by demanding that it be undone. We contend that there is no jurisdiction under the 1934 Act to nullify a merger at the behest of the Commission once it has been accomplished. This was the view of the trial court (R. 800-01). The trial judge held that the relief sought is outside the scope of that provided in the relief section of the 1934 Act, Section 21(e), 15 U.S.C. Sec. 78u(e).

Appellees and the trial court were of course thoroughly familiar with *J. I. Case Co. v. Borak,* 377 U.S. 426, 84 Sup.Ct. 1555, 12 L.Ed.2d 423 (1964) which holds that there may be a retrospective remedy in suits by private persons brought under Section 27 of the 1934 Act, 15 U.S.C. Sec. 78aa. The *Borak* case did not purport to be brought under Section 21(e) of the same statute, 15 U.S.C. Sec. 78n(e) which expressly provides for the relief which the Commission as a plaintiff may obtain. That section provides that the Commission may get relief where a person "is engaged or about to engage" in illegal activities, and in such circumstances provides that an injunction or restraining order may be obtained. Not a syllable of that section suggests that the Commission may obtain relief where the action complained of is already an accomplished fact. Unlike the *Borak* case, the instant action is expressly based on Section 21(e); the complaint exactly and precisely says, "This action arises under Section 21(e) of the Act," R. 424.

Whatever general equities the Commission may be able to claim, if any, under *Borak,* did not see fit to claim them here. It rested solely and exclusively upon a statutory provision which in the clearest language conceivable is prospective only. It may not after the event switch to some wholly other claim of remedy, and the court below

correctly held that this remedy it not within the scope of Section 21(e). Not a single case cited by the Commission suggests, directly or indirectly, that a merger can be undone on the basis of any authority of Section 21(e), and we know of no such case.

In support of its contention that such retrospective relief may be granted to it, the Commission cites *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 61 Sup.Ct. 229, 85 L.Ed. 189 (1940), and *Securities and Exchange Commission v. Los Angeles Trust Deed & Mortgage Exchange*, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961). In *Deckert* the Court granted rescission, the very relief provided for by Section 12(2) of the Securities Act of 1933, 15 U.S.C. Sec. 77*l*, under which the action was brought. In the *Los Angeles Trust Deed & Mortgage* case, this Court, recognizing it as the most difficult point in the appeal, upheld the appointment of a receiver, but only pendente lite until the registration provisions of the securities acts were complied with and as ancillary relief to the injunction issued. This Court specifically declined to permit the undoing of anything which had been done when it modified the District Court's order by striking authority for the receiver to accomplish liquidation and stated in its opinion at page 182:

> "It is appreciated that the conservator type of receivership which we have insisted upon is not well adapted to a business the very essence of which is promotion and, apparently, depends on a constant inflow of new business. However, a receiver does seem required. But, we are not yet willing to order liquidation. That would establish perhaps generally a special additional penalty for failure to comply with the two Acts of Congress with which we were here concerned and we doubt that this was within the contemplation of Congress."

CONCLUSION

It is respectfully submitted that the judgment of the court below should be affirmed.

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Attorneys for Appellees

March, 1967.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19, and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

John P. Frank

(Appendix Follows)

Appendix

1. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j:

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

2. Section 12(g)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l*:

78*l* Registration requirements for securities

* * * * * * *

(g) (1) Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce shall—

(A) within one hundred and twenty days after the last day of its first fiscal year ended after July 1, 1964, on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by seven hundred and fifty or more persons; and

(B) within one hundred and twenty days after the last day of its first fiscal year ended after two years from July 1, 1964, on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by five hundred or more but less than seven hundred and fifty persons,

register such security by filing with the Commission a registration statement (and such copies thereof as the Commission may require) with respect to such security containing such information and documents as the Commission may specify comparable to that which is required in an application to register a security pursuant to subsection (b) of this section. Each such registration statement shall become effective sixty days after filing with the Commission or within such shorter period as the Commission may direct. Until such registration statement becomes effective it shall not be deemed filed for the purposes of section 78r of this title. Any issuer may register any class of equity security not required to be registered by filing a registration statement pursuant to the provisions of this paragraph. The Commission is authorized to extend the date upon which any issuer or class of issuers is required to register a security pursuant to the provisions of this paragraph.

(2) The provision of this subsection shall not apply in respect of—

* * * * * * *

(G) any security issued by an insurance company if all of the following conditions are met:

(i) Such insurance company is required to and does file an annual statement with the Commissioner of Insurance (or other officer or agency performing a similar function) of its domiciliary State, and such annual statement conforms to that prescribed by the National Association of Insurance Commissioners or in the determination of such State commissioner, officer or agency substantially conforms to that so prescribed.

(ii) Such insurance company is subject to regulation by its domiciliary State of proxies, consents, or authorizations in respect of securities issued by such company and such regulation conforms to that prescribed by the National Association of Insurance Commissioners.

(iii) After July 1, 1966, the purchase and sales of securities issued by such insurance company by beneficial owners, directors, or officers of such company are subject to regulation (including reporting) by its domiciliary State substantially in the manner provided in section 78p of this title.

3. Section 14(a) of the Securities Exchange Act of 1934, U.S.C. § 78n:

§ 78n. Proxies

(a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy

or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78*l* of this title.

4. Section 21(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78u:

* * * * * * *

(e) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.

5. McCarran-Ferguson Insurance Regulation Act, 15 U.S.C. § 1012:

§ 1012. Regulation by State law; Federal law relating specifically to insurance; applicability of certain Federal laws after June 30, 1948

(a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided,* That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

6. Rule 10b-5 Promulgated Under the Securities Exchange Act of 1934, 17 CFR 240.10b-5:

§ 240.10b-5 Employment of manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

7. Rule 14a-9 Promulgated Under the Securities Exchange Act of 1934, 17 CFR 240.14a-9:

§ 240.14a-9 False or misleading statements

(a) No solicitation subject to §§ 240.14a-1 to 240.14a-10 shall be made by means of any proxy statement, form of proxy, notice of meeting, or other communication, written or oral containing any statement which at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

Note: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this rule:

(a) Predictions as to specific future market values, earnings, or dividends.

(b) Material which directly or indirectly impugns character, integrity or personal

reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation.

8. Arizona Insurance Code Provisions on Mergers:

§ 20-731. Merger or consolidation of stock insurers

A. A domestic stock insurer of any kind may merge or consolidate with another domestic or foreign stock insurer by complying with the provisions of general law governing the merger or consolidation of stock corporations formed for profit, but subject to subsection B of this section.

B. No such merger or consolidation shall be effectuated unless in advance thereof the plan and agreement therefor have been filed with and approved in writing by the director of insurance. The director shall give his approval within a reasonable time after filing unless he finds the plan or agreement:

1. Is contrary to law.

2. Inequitable to the stockholders of any domestic insurer involved.

3. Would substantially reduce the security of and service to be rendered to policyholders of the domestic insurer in this state or elsewhere.

C. If the director does not approve the plan or agreement he shall so notify the insurer in writing specifying his reasons therefor.

9. Arizona Corporate Code Provisions on Mergers:

ARTICLE 11. CONSOLIDATION OR MERGER

§ 10-341. Consolidation authorized

Two or more corporations may be consolidated, and continue as one of the constituent corporations or by forming a new corporation.

§ 10-342. Consolidation agreement

When two or more corporations desire to consolidate, a majority of the directors of each corporation affected may enter into an agreement setting forth the terms and conditions of the proposed consolidation, including:

1. Capitalization and number of shares of capital stock of the proposed consolidated corporation.

2. Classes into which the shares shall be divided and the value placed on each.

3. Manner of converting the shares and assets of the retiring corporations.

4. Whether one of the constituent corporations is to be continued or a new corporation formed.

5. Number of directors and officers.

6. Method of carrying into effect the terms of the agreement.

7. Other details necessary to disclose all matters affecting the consolidation.

§ 10-343. Notice of proposed consolidation

A. Notice of proposed consolidation of corporations shall be given by each corporation affected by publication in a newspaper published in the county in which its principal office is located, once each week for four successive weeks immediately prior to the meeting at which the proposed action is to be voted upon, and by mail to the last known address of each stockholder as shown by the books of the corporation, not less than thirty days prior to the meeting.

B. The notice shall contain:

1. The time and place of the meeting.
2. The value of the assets of the corporation.
3. The amount of its indebtedness.
4. A copy of the agreement of the boards of directors, as provided in § 10-342.

§ 10-344. Submission of agreement to shareholders

A. The agreement of the boards of directors to consolidate shall be submitted to the shareholders of each constituent corporation, who may vote in person or by proxy for the adoption or rejection thereof at either an annual or special stockholders' meeting.

B. If all outstanding shares in the corporation are of one class and of equal par value each share shall entitle the holder to one vote. If the shares are of different classes or of different par values, relative voting rights shall be upon such basis as the charter or by-laws of the corporation may provide, or in the absence of any express provision, then in the ratios of respective par values, treating each no par share, if any, as of a par value equal to the par value of

the outstanding shares of the corporation of highest par value.

C. If two thirds of the stock, valued as provided by this section, is voted in favor of consolidation, the agreement shall be declared adopted and the vote certified on the agreement by the secretary of the corporation so voting. The agreement shall be signed and acknowledged by the president and secretary of the corporation, and its seal affixed thereto.

§ 10-345. Formal requirements for consolidation

A. If an agreement for consolidation, ratified and certified by each constituent corporation as provided in § 10-344, provides that one of the constituent corporations shall be continued as the consolidated corporation, the certified agreement shall be filed in the office of the corporation commission, and one copy thereof, certified by the corporation commission, shall be recorded in the office of the county recorder of each county in which one of the constituent corporations has its principal office. The consolidation shall thereupon be deemed consummated and the separate existence of the constituent corporations to have ceased, and the consolidated corporation shall become a single corporation in accordance with the agreement, under its articles and name, possessing all powers and subject to all restrictions and disabilities of corporations organized for profit.

B. If an agreement for consolidation, ratified and certified by each constituent corporation as provided in § 10-344, provides for the formation of a new corporation, new articles of incorporation, reciting the consolidation and naming the constituent corporations,

shall be prepared and filed in the manner required by law.

§ 10-346. Transfer of assets and liabilities

All debts due to, and all property and assets of, each corporation consolidated as provided in this article shall vest in the consolidated corporation, but rights of creditors against and liens on the property of each corporation consolidated shall be preserved unimpaired. The debts, liabilities and duties of the corporations consolidated shall pass to the consolidated corporation, and may be enforced against it in the same manner and to the same extent as if incurred or contracted by, or imposed upon it.

§ 10-347. Payment for shares of dissenting shareholder; valuation

A. Any shareholder of the corporations consolidating who votes to reject the agreement, and who does not consent to the agreed manner of converting the shares of stock, shall be paid in cash the fair value of his stock, based on its pro rata share of the fair value of the net assets of the corporation of which he is a shareholder as of the time of the consolidation meeting. In the event of disagreement, such value shall be determined by the court in an action by either the dissenting shareholder or the corporation, and the corporation's existence shall be continued for that purpose.

B. Every shareholder shall be deemed to have consented to such method of conversion unless he gives written notice of dissent to the president, secretary or statutory agent of the corporation not later than

two days after the consolidation meeting, and unless he commences an action in the superior court of the county in which the principal office of the corporation is located to fix the value of his shares, not later than thirty days after such meeting. After the hearing the court shall determine the value of the dissenting stock, and the corporation shall pay the owner the sum so determined within thirty days after final judgment, whereupon the stock shall be transferred to the corporation.

§ 10-348. Consolidation or merger of domestic and foreign corporations

A. One or more domestic corporations and one or more foreign corporations may be merged or consolidated in the following manner, if the merger or consolidation is permitted by the laws of the state under which each foreign corporation is organized:

1. Each domestic corporation shall comply with the provisions of this article with respect to the merger or consolidation, as the case may be, of domestic corporations. Each foreign corporation shall comply with the applicable provisions of the laws of the state under which it is organized.

2. If the surviving or new corporation, as the case may be, is incorporated under the laws of another state, it shall comply with the provisions of article 17 of this chapter, if it is to transact any business in this state.

B. The surviving or new corporation may be either a foreign or domestic corporation, and when merged the surviving corporation shall be deemed to continue to exist under the laws of the state of its corporation.

§ 10-349. Effect of merger or consolidation; rights of shareholders

A. The provisions of this article, relative to the merger or consolidation of domestic corporations, shall apply to a domestic corporation which merges or consolidates with a foreign corporation or corporations. The effect of the merger or consolidation shall be the same as in the case of the merger or consolidation of domestic corporations except, if the surviving or new corporation is incorporated under the laws of another state, to the extent that the law of the other state otherwise provides.

B. The provisions of this article shall apply to the rights of shareholders of any one or more of the constituent corporations which are domestic corporations.

10. Arizona's "Little McCarran Act" provisions.

ARTICLE 6.

UNFAIR PRACTICES AND FRAUDS

§ 20-441. Purpose of article

Among the purposes of this article is the regulation of trade practices in the business of insurance in accordance with the intent of Congress as expressed in the Act of Congress of March 9, 1945, 59 Stat. 33, by defining, or providing for the determination of, all such practices in this state which constitute unfair methods of competition or unfair or deceptive acts or practices and by prohibiting the trade practices so defined or determined.

§ 20-442. Unfair trade practices prohibited

No person shall engage in this state in any trade practice which is prohibited by this article, or defined

in this article as, or determined pursuant to this article to be, an unfair method of competition or an unfair or deceptive act or practice in the business of insurance.

§ 20-443. Misrepresentations and false advertising of policies

No person shall make, issue or circulate, or cause to be made, issued or circulated, any estimate, illustration, circular, sales material or statement:

1. Misrepresenting the terms of any policy issued or to be issued or the benefits or advantages promised thereby or the dividends or share of the surplus to be received thereon.

2. Making any false or misleading statement as to the dividends or share of surplus previously paid on similar policies.

3. Making any misleading representation or any misrepresentation as to the financial condition of any insurer or as to the legal reserve system upon which any life insurer operates.

4. Using any name or title of any policy or class of policies misrepresenting the true nature thereof.

5. Making any misrepresentation to any policyholder for the purpose of inducing or tending to induce such policyholder to lapse, forfeit, surrender, retain or convert any insurance policy.

§ 20-444. False or deceptive advertising of insurance or status as insurer

A. No person shall make, publish, disseminate, circulate or place before the public, or cause, directly or indirectly, to be made, published, disseminated, circulated or placed before the public, in a newspaper,

magazine or other publication, or in the form of a notice, circular, pamphlet, letter or poster, or over any radio or television station, or in any other way, any advertisement, announcement, sales material or statement containing any assertion, representation or statement with respect to the business of insurance or with respect to any person in the conduct of his insurance business, which is untrue, deceptive or misleading.

B. No person that is not an insurer shall assume or use any name which deceptively infers or suggests that it is an insurer.

§ 20-445. Defamation

No person shall make, publish, disseminate or circulate, directly or indirectly, or aid, abet or encourage the making, publishing, disseminating or circulating of any oral or written statement or any pamphlet, circular, article, sales material or literature which is false or maliciously critical of or derogatory to the financial condition of an insurer, and which is calculated to injure any person engaged in the business of insurance, or any domestic corporation or group being formed pursuant to this code for the purpose of becoming an insurer. This provision shall not be deemed to restrict the right, lawfully exercised, of newspapers, magazines, radio and television stations, and similar public media for news dissemination, objectively to publish and disseminate news.

§ 20-446. Acts tending to result in unreasonable restraint or monopoly of insurance business

No person shall enter into any agreement to commit, or by any concerted action commit, any act of boy-

cott, coercion or intimidation resulting in or tending to result in unreasonable restraint of, or monopoly in, the business of insurance.

§ 20-447. False financial statements or records

A. No person shall file with any public official, or make, publish, disseminate, circulate or deliver to any person, or place before the public, or cause, directly or indirectly, to be made, published, disseminated, circulated or delivered to any person, or placed before the public, any false statement of the financial condition of an insurer with intent to deceive.

B. No person shall make any false entry in any book, report or statement of any insurer or other person required to have records under this title, with intent to deceive any agent or examiner lawfully appointed to examine into its condition or into any of its affairs, or any public official to whom the insurer or person is required by law to report, or who has authority by law to examine into its condition or into any of its affairs, or, with like intent, wilfully omit to make a true entry of any material fact pertaining to the business of the insurer or person in any book, report or statement thereof.

[As corrected April 5, 1967]

No. 21,146

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

v.

NATIONAL SECURITIES, INC., a corporation, NATIONAL LIFE & CASUALTY INSURANCE COMPANY, a corporation, ROBERT A. WALLACE, ROBERT C. BOHANNAN, JR., ARTHUR W. SAFFERT, TED WILKINS, JOHN S. BARRETT, JOSEPH B. SETTER, BREEFERD W. LARGE, JR. and PRODUCERS LIFE INSURANCE COMPANY, a corporation (also known as NATIONAL PRODUCERS LIFE INSURANCE COMPANY),

Defendants-Appellees.

APPEAL FROM UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ARIZONA (Phoenix Division)

REPLY BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF-APPELLANT

FILED

APR 7 1967

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I N D E X

TABLE OF CASES

Cases:

Cases--continued | Page

No. 21,146

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

v.

NATIONAL SECURITIES, INC., a corporation, NATIONAL LIFE & CASUALTY INSURANCE COMPANY, a corporation, ROBERT A. WALLACE, ROBERT C. BOHANNAN, JR., ARTHUR W. SAFFERT, TED WILKINS, JOHN S. BARRETT, JOSEPH B. SETTER, BREEFERD W. LARGE, JR. and PRODUCERS LIFE INSURANCE COMPANY, a corporation (also known as NATIONAL PRODUCERS LIFE INSURANCE COMPANY),

Defendants-Appellees.

APPEAL FROM UNITED STATES DISTRICT COURT FOR THE DISTRICT OF ARIZONA (Phoenix Division)

REPLY BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, PLAINTIFF-APPELLANT

I. THE CONSOLIDATION OF PRODUCERS LIFE INSURANCE COMPANY AND NATIONAL LIFE AND CASUALTY INSURANCE COMPANY INVOLVED PURCHASES AND SALES OF SECURITIES WITHIN THE MEANING OF SECTION 10(b) OF THE SECURITIES EXCHANGE ACT AND RULE 10b-5.

The district court did not reach the question whether the consolidation of Producers Life and National Life into National

Producers involved purchases or sales of securities in connection with which the alleged fraud occurred. Appellees nevertheless contend (Br 29) that "unless a statutory merger is a 'purchase or sale' within the meaning of Rule 10b-5, that section has no application to the instant case at all." This argument wholly ignores the fraud alleged in the purchase by appellees of the treasury stock of Producers Life.1/

On the merits, appellees ignore the broad definitions of the terms "purchase" and "sale" in the Securities Exchange Act of 1934 and

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1/ Appellees contend (Br 46-47) that no question was presented to the district court involving defendants' violations of Section 10(b) and Rule 10b-5 in connection with National Securities' purchase of Producers Life's treasury stock. The Commission's original complaint (R. 6, ¶¶5,6) and its Amended and Supplemental Complaint (R. 428, ¶5) both set forth with particularity the facts concerning National Securities' purchase of the Producers Life treasury stock as part of its allegation that defendants' acts and practices constituted an unlawful scheme to defraud Producers Life and its stockholders (R. 3, 425).

In any event, as appellees recognize (Br 30), the district court did not purport to decide all of the issues in the case but disposed of it solely on the ground that the application of the antifraud provisions of the Securities Exchange Act was precluded by the McCarran Act and that certain of the relief sought by the Commission was unavailable to it. Accordingly, the rationale underlying the decisions of this Court cited by appellees (Br 47) does not apply. As pointed out in Stephens v. Arrow Lumber Co., 354 F. 2d 732, 734 (1966) and Partenweederei, MS Belgrano v. Weigel 313 F. 2d 423, 425 (1962), certiorari denied, 373 U.S. 904 (1963), the policy requiring that contentions not be raised for the first time on appeal is to provide this Court with "the benefit of the district court's wisdom" on the issues raised. This consideration is inapplicable where the case is disposed of on other issues. Indeed, the very rationale of those decisions of "preventing piecemeal litigation and consequent waste of the time of both trial and appellate courts" seems to require that all of the dispositive legal issues be herein decided.

the necessity that these terms not be so narrowly construed that investors would be deprived of the protections Congress intended them to have. (See pp. 22-28 of our opening brief.) They rely in large part (Br 33-35) upon the position taken by the Commission in an amicus curiae brief filed in this Court almost 25 years ago in National Supply Co. v. Leland Stanford Jr. University, 134 F. 2d 689, involving the definition of "sale" in the Securities Act of 1933 and upon this Court's summary agreement therewith in that case as an alternative ground for its reversal of the judgment of the district court. They point to superficial distinctions in the district court decisions contrary to their position [2/] and of the district court cases on which they rely, one has since been reversed (Br 40).

2/ As cited at page 28 of our opening brief, these were Simon v. New Haven Board and Carton Co., 250 F. Supp. 297 (D. Conn., 1966); Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369 (D. Del., 1965); and the unreported case of Securities and Exchange Commission v. Anaconda Lead & Silver Co. (D. Colo., No. 6189, July 11, 1961).

Despite appellees' attempted distinction, it is clear that the Simon case involved a merger which the plaintiff therein contended "was authorized by the shareholders of New Haven on the basis of falsified and misleading reports and proxy statements . . . ." 250 F. Supp. at 298. Accordingly, the case appears to be on all fours with the instant case and we do not understand appellees' attempted distinction any more than we understand their reference in the discussion of that case to the New Haven Railroad (Br 40), which was not involved therein.

Appellees also suggest that the Voege case "is not in the real sense a merger" (Br 40), but the fraud alleged was in bringing about a merger of one corporation into another, resulting in the forced surrender of the plaintiff's stock in the merged corporation at less than its real value, 241 F. Supp. at 372, 375-376. As noted in the text, infra, pp. 6-7, with respect to Vine v. Beneficial Finance Co., the basis of the "no sale theory" relied on by appellees in this case is the same as that which would underlie the contention that there is "no sale" in the type of short form merger involved in Voege.

Appellees do not refer to Securities and Exchange Commission v. Anaconda Lead & Silver Co., but instead purport to distinguish Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D. N.Y., 1965), a case not cited in our opening brief.

Producers involved purchases or sales of securities in connection with which the alleged fraud occurred. Appellees nevertheless contend (Br 29) that "unless a statutory merger is a 'purchase or sale' within the meaning of Rule 10b-5, that section has no application to the instant case at all." This argument wholly ignores the fraud alleged in the purchase by appellees of the treasury stock of Producers Life. 1/

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Appellees do not refer to _Securities and Exchange Commission_ v. _Anaconda Lead & Silver Co._, but instead purport to distinguish _Barnett_ v. _Anaconda Co._, 238 F. Supp. 766 (S.D. N.Y., 1965), a case not cited in our opening brief.

Subsequent to the filing of appellees' brief, the United States Court of Appeals for the Second Circuit, on March 13, 1967, reversed Vine v. Beneficial Finance Co., 252 F. Supp. 212 (S.D. N.Y., 1966), referred to at page 28 in our opening brief and in appellees' brief at pages 39-40. Vine v. Beneficial Finance Co., CCH Fed. Sec. L. Rep. ¶ 91,906.[3] In that case the plaintiff-appellant, a stockholder of Crown Finance Company, Inc., alleged that officers and directors of that corporation conspired to merge it into Beneficial Finance Co. at the expense of Crown shareholders and for the benefit of the former Crown directors and of Beneficial. The scheme was accomplished by the purchase of Crown stock by Beneficial from the directors of Crown; by a public offer of Beneficial to purchase Crown stock, without disclosing material facts; and, sufficient stock having been thus acquired by Beneficial, by a short form merger of Crown into Beneficial. The plaintiff-appellant had not tendered his shares in response to Beneficial's offer, but after the short form merger he had "only the options of exchanging his stock for $3.29 a share, pursuant to appellee's offer, or pursuing his right of appraisal, which would also result in cash from appellee" (Slip Op. 1540). The question was whether the plaintiff-appellant was a seller of securities within the meaning of Section 10(b) of the Securities Exchange Act and Rule 10b-5.

As stated by the Court of Appeals, the district court held "that since Vine neither accepted the offer to purchase his stock nor surrendered

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3/ The Slip Opinion is reproduced in the Appendix to this brief except for the portions of the opinion numbered "II", dealing with the question whether the notice of appeal was timely filed; numbered "IV", dealing with the question of whether an amended complaint should have been permitted to be filed; and numbered "V", dealing with the question as to the propriety of derivative and class actions.

his stock pursuant to the statutory short form merger, he was not a seller, and therefore there could have been no fraud as to him in connection with the purchase or sale of a security" (Slip Op. 1538). The Court of Appeals disagreed with this "narrow holding" (ibid.), stating (Slip Op. 1541):

> "Since, in order to realize any value for his stock, appellant must exchange the shares for money from appellee, as a practical matter appellant must eventually become a party to a 'sale,' as that term has always been used."

It held that plaintiff-appellant was a "seller" under the Securities Exchange Act (Slip Op. 1542), noting that the various transactions were "all part of a single fraudulent scheme," which was "a classic example of deception of an entire class of . . . stockholders" within the reach of Section 10(b) and Rule 10b-5 (Slip Op. 1543).4/

4/ In the instant case appellees ask this Court to look separately at each aspect of the fraud (Br 26-27, 47-48). Whether or not the purchase of stock from the selling directors of Producers Life, the purchase of Producers Life treasury stock, the agreement whereby National Securities was to manage Producers Life, or the transfer of shares of Producers Life by National Securities to National Life would separately constitute a violation of Rule 10b-5, these activities together, as "part of a single fraudulent scheme," as alleged, are an "example of deception" of the public security holders of Producers Life. Whether or not the scheme in the instant case is a "classic" or novel fraud is, of course, not determinative. The Court of Appeals for the Second Circuit stated in a decision just handed down:

> "We believe that §10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws."

A. T. Brod & Co. v. Perlow, ___ F. 2d ___ (C.A. 2, No. 31028, March 27, 1967).

Thus in the first appellate holding as to the application to a merger of Rule 10b-5 (and the first appellate discussion involving the application to a merger of the antifraud provisions of the federal securities laws since Leland Stanford), it is squarely held that a merger involves a purchase and sale of securities within the meaning of the Securities Exchange Act. In reaching this result, the Court of Appeals in Vine noted that "whatever stance [the Commission] . . . adopted two decades ago" in the Leland Stanford case, in Vine it strongly urged that the merger involved "resulted in a purchase and sale of plaintiff's stock within the meaning of Rule 10b-5" (Slip Op. 1545).

The Court of Appeals also noted in Vine that the appellee in that case vigorously contended that the plaintiff could not be "a defrauded seller because nothing was asked of him, no representations were made to him--indeed, under the merger statute, nothing had to be communicated to him but notice of his right to the offered $3.29 or to demand an appraisal" (Slip Op. 1543). This contention is comparable to appellees' argument here (Br 34, 36), incorporated by reference from the Commission' brief in Leland Stanford, that there is no sale in a merger because "the alteration of the stockholder's security occurs not because he

consents to an exchange, but because the corporation by authorized corporate action converts his security from one form to another."

As we have seen, the Court of Appeals in Vine held that even though the plaintiff still had his stock certificate in Crown he should nonetheless be deemed a seller. We submit that this realistic position should also be applied here, even though appellees point out (Br 32) that a former Producers Life stockholder is not required to exchange his stock certificate and can retain the "piece of paper" representing his shares in Producers Life.

Appellees also suggest (Br 32) that somehow Rule 10b-5 is not applicable here because the consolidation occurred under Arizona law and had to be approved by the State Director of Insurance, but, as noted by the Court of Appeals in Vine, citing J.I. Case Co. v. Borak, 377 U.S. 426, 433-435 (1964), "the existence of a state remedy" cannot, even in a private action, negate a federal right (Slip Op. 1544-1545). Certainly in an enforcement action by a federal agency, charged with administering a law for which violations can be prosecuted only in the federal courts,[5/] a possible state remedy is irrelevant.

5/ See Section 27 of the Securities Exchange Act, 15 U.S.C. 78aa.

II. APPELLEES HAVE NOT SHOWN THAT THE McCARRAN ACT PRECLUDES THE APPLICATION OF THE ANTIFRAUD PROVISIONS OF THE SECURITIES EXCHANGE ACT AND RULE 10b-5 TO SALES AND PURCHASES OF SECURITIES INVOLVED IN A CONSOLIDATION OF INSURANCE COMPANIES APPROVED BY A STATE INSURANCE OFFICIAL.

Appellees do not express disagreement with United States v. Sylvanus 192 F.2d 96 (C.A. 7, 1951), holding that the federal mail fraud statute is applicable to the sale of securities of insurance companies, and with reference thereto they concede (Br 26) that "[t]he McCarran Act may permit supplemental or ancillary or additional Federal regulation which somehow relates to insurance . . . ." They suggest, inconsistently, that such ancillary regulation does not occur with respect to fraud in connection with the transfer of insurance company stock in violation of the Securities Exchange Act. For reasons set out in our opening brief (pp. 16-17) it is clear that the McCarran Act, which was enacted to preserve state authority over the "business of insurance", does not and was not intended to limit the federal laws dealing with transactions in securities.

The McCarran Act, as we pointed out in our opening brief (p. 13), was adopted in response to a Supreme Court decision that the antitrust laws were applicable to insurance companies. Section 2(b) of that Act, 15 U.S.C. 1012(b), limited the application of the antitrust laws and the Federal Trade Commission Act to insurance companies in those states where laws regulating the business of insurance were not adopted. All but one of the cases relied upon by appellees (Br 23-26) involved the question whether the antitrust laws or Federal Trade Commission Act should be applicable or whether "the business of insurance" was "regulated by State law" within the meaning of the McCarran Act. The remaining case, Zachman v. Erwin,

186 F. Supp. 691 (S.D. Tex., 1960), holds that the antifraud provisions of the Securities Act of 1933 are applicable in an action to rescind the purchase of a Texas insurance company's securities. By referring to the fact that "the Insurance Code of Texas" revealed "no special remedy for purchasers against persons who have defrauded them in the sale of insurance company securities" (186 F. Supp. at 694), the court could well have been emphasizing the need for the application of the Securities Act without in any way implying, as appellees contend (Br 24), that, were there such a remedy in the Texas statute, the Securities Act would have been "superseded."

Appellees also suggest (Br 26-29) that the application of the antifraud provisions of the Securities Exchange Act to the instant case would obliterate the functions of the Arizona Director of Insurance. Even if the state statute should specifically give the Director power to pass upon the question whether there is fraud in transactions in securities of insurance companies, such a provision should not remove these transactions from the scope of the federal securities laws. Compare, Securities and Exchange Commission v. Variable Annuity Life Insurance Co., 359 U.S. 65, 69 (1959); and Prudential Insurance Co. v. Securities and Exchange Commission, 326 F. 2d 383, 388 (C.A. 3, 1964).[6/] The Commission's

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6/ The frivolous nature of appellees' argument appears from their contention (Br 49) that the Commission should have appealed from the decision of the Arizona Director of Insurance approving the merger. Section 21(e) of the Securities Exchange Act, 15 U.S.C. 78u(e), provides that "[w]henever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions . . ." of the Act or rules thereunder, "it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices . . . ." And Section 27 of the Act gives exclusive jurisdiction to the federal courts over violations of the Act and rules thereunder.

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action in no way impinges upon the power of the Arizona Director of Insurance to regulate the business of insurance in the State of Arizona. It merely attempts to enforce the antifraud provisions of the Securities Exchange Act in connection with purchases and sales of insurance company securities.

III. THE POWERS OF THE COMMISSION TO REGULATE THE PROXY SOLICITING MATERIAL OF SOME CORPORATIONS GRANTED BY SECTION 14(a) OF THE SECURITIES EXCHANGE ACT DO NOT PRECLUDE THE APPLICATION OF SECTION 10(b) OF THE ACT AND RULE 10b-5 TO SECURITIES TRANSACTIONS INDUCED BY FRAUDULENT PROXY STATEMENTS.

Appellees recognize (Br 41) that in enacting the Securities Exchange Act Congress gave the Commission "a mighty arsenal of weapons" and that all of these "weapons" are not contained "in any one section or in any one rule." They contend (Br 41-46), however, that Section 10(b) of the Act cannot apply to fraudulent proxy solicitations because Section 14(a) of the Act, 15 U.S.C. 78n(a), gives the Commission specific powers over the proxy solicitations of some companies. 7/ In effect, appellees ask this Court to hold that the Commission is powerless to seek to enjoin fraudulent representations designed to induce persons to sell or purchase securities of those companies which

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7/ Appellees also contend (Br 44) that the district court disposed of this issue in its opinion and that, since the Commission has not contested this determination, the appeal should be dismissed. But Judge Mathes (R. 797-798) stated in this regard only that Section 14 was not applicable--a statement with which we agree. He decided the case on the assumption that Section 10(b) may be applicable to proxy solicitation material--an assumption with which we agree (R. 798). Accordingly, there was no question in this regard for the Commission to raise on appeal.

are not subject to the Commission's proxy rules, so long as the fraudulent representations are confined to proxy statements. Congress could not have intended this result in a statute designed to make "transactions in securities . . . reasonably complete and effective." Section 2 of the Act, 15 U.S.C. 78b. 8/

It is not uncommon for securities frauds to involve a violation of the provisions of several sections of the securities laws or rules promulgated by the Commission, for neither Congress nor the Commission has been primarily concerned with categorizing securities frauds into neat pigeonholes; rather their concern has been with preventing unfair and inequitable practices in securities transactions. For example, a fraud committed on a purchaser or seller of securities by a broker-dealer would violate Section 15(c) of the Securities Exchange Act, 15 U.S.C. 78o(c), as well as Section 10(b) and Rule 10b-5--and also, in the case of a purchaser, Section 17(a) of the Securities Act, 15 U.S.C. 77q(a). Similarly, a manipulation of securities might violate Section 9(a) of the Securities Exchange Act, 15 U.S.C. 78i(a), and the antifraud provisions cited above. This Court has held that defrauded purchasers

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8/ The court below referred to the unreported district court decision in Borak v. J. I. Case Co., (E.D. Wis., No. 56 C247, 1962), which had dismissed a complaint alleging violations of both the Commission's proxy rules and Rule 10b-5. The Court of Appeals, in reversing the order dismissing the complaint, held that Section 10(b) had no application to the facts alleged in the complaint but specifically stated that it expressed "no opinion" on the question "whether misleading proxy material may, under any circumstances, constitute a manipulative and deceptive device within the prohibition of that Section," Borak v. J. I. Case Co., 317 F. 2d 838, 847 (C.A. 7, 1963), aff'd on other grounds, 377 U.S. 426 (1964).

of securities have an implied right of action under Section 10(b) of the Securities Exchange Act, despite the fact that Congress specifically made available to such purchasers certain civil remedies in Sections 11 and 12 of the Securities Act, 15 U.S.C. 77k and l. Matheson v. Armbrust, 284 F. 2d 670 (1960), certiorari denied, 365 U.S. 870 (1961); Ellis v. Carter, 291 F. 2d 270 (1961).

The argument is comparable to urging that Section 10(b) and Rule 10b-5 do not apply to transactions in securities by corporate insiders because specific provisions relating to securities transactions by insiders of certain corporations are found in Section 16 of the Act. 9/ The activities of insiders, however, have repeatedly been found to be subject to Section 10(b) and Rule 10b-5. 10/ Indeed, the theory advanced by

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9/ Section 16, inter alia, provides for the reporting of the transactions in equity securities by officers, directors and certain large security holders of corporations listed on exchanges and certain other widely-held corporations and provides that any such person who purchases and sells (or sells and purchases) the equity securities of his corporation within a six-month period shall be liable to the corporation for his profits.

10/ List v. Fashion Park, Inc., 340 F. 2d 457, 461-462 (C.A. 2), certiorari denied, 382 U.S. 811 (1965); Kohler v. Kohler Co., 319 F. 2d 634, 638 (C.A. 7, 1963); Reed v. Riddle Airlines, 266 F. 2d 314 (C.A. 5, 1959); Cochran v. Channing Corp., 211 F. Supp. 239, 242-243 (S.D. N.Y., 1962); Speed v. Transamerica Corp., 99 F. Supp. 808, 828-829 (D. Del., 1951), final judgment awarded, 135 F. Supp. 176, 186-187 (D. Del., 1955), aff'd as modified, 235 F. 2d 369 (C.A. 3, 1956); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa.), modified in other respects, 83 F. Supp. 613 (E.D. Pa., 1947); Securities and Exchange Commission v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 278 (S.D. N.Y., 1966), appeal pending (C.A. 2); Mansfield Hardware Lumber Co. v. Johnson, 268 F. 2d 317, 319 n.3 (C.A. 5) (dictum), certiorari denied, 361 U.S. 885 (1959). Cf. Securities and Exchange Commission v. Chenery Corp., 318 U.S. 80, 9 (1943).

appellees, if pressed to its logical conclusion, would lead to the absurdity that the antifraud provisions of the Securities Act and of the Securities Exchange Act are not to be applied to any sales of securities, since it could be argued that securities sales are dealt with under Section 5 of the Securities Act, 15 U.S.C. 77e, which requires the registration of non-exempt securities offerings.

Appellees' argument also misconceives important differences between Sections 14(a) and 10(b). Section 14(a) makes it unlawful to solicit proxies in contravention of rules adopted by the Commission. Proxies may be sought for such matters as the election of directors, selection of auditors, sales of substantial assets or amendments to bylaws, or for matters involving the purchase or sale of securities, such as the issuance of stock options or the approval of a proposed merger. Section 10(b) of the Act on the other hand permits the Commission to adopt rules precluding manipulative or deceptive devices only "in connection with the purchase or sale of any security." The Commission would be unable to adopt rules under Section 10(b) relating to proxies not involving "the purchase or sale of any security." Thus the Commission was not "disingenuous," as appellees suggest (Br 45-46), in urging the 1964 amendment to the Securities Exchange Act which gave it authority to regulate the proxy solicitation of certain widely-held companies not previously subject to the proxy rules.

Moreover, the quantum of disclosure under Section 14(a) of the Act and the proxy rules is different from that required by Section 10(b).

Pursuant to Section 14 the Commission has adopted a comprehensive set of rules governing proxies and a detailed schedule of information to be included in proxy statements. See Rules 14a-1 through 14a-12, 17 CFR 240.14a-1 through 14a-12; Schedule 14A. To avoid violation of Section 10(b), however, pursuant to which no specific items of disclosure are required, disclosure which does not include everything required in a proxy statement may be adequate.

IV. THE ISSUE OF INDISPENSABLE PARTIES IS NOT PROPERLY BEFORE THIS COURT.

Defendants contend (Br 17-21) that the former directors of Producers Life who sold their Producers Life stock to National Securities ("selling directors") are indispensable parties to this action and that for want of their joinder, the action should be dismissed. 11/ This issue, we submit, is not properly before this Court.

The question of the indispensability of the selling directors as parties, as appellees recognize (Br 17), goes to the question of the relief sought. The refusal of courts to grant relief when indispensable parties have not been joined is derived from an old equity practice designed to afford complete relief in an action. See State of Washington v. United States, 87 F. 2d 421 (C.A. 9, 1936). As this Court recognized in that case (87 F. 2d at 427), the failure to join indispensable parties is not jurisdictional, especially in an action under a federal statute not based on diversity of citizenship. See 3 Moore's Federal Practice ¶19.05.

11/ In view of the fact that the appellees (R. 507-509) opposed the Commission's motion to rename the selling directors of Producers Life as defendants, it comes with ill grace for them to now assert before this Court that the selling directors of Producers Life were indispensable parties.

The question of indispensable parties will not arise in the instant case if the district court in its discretion should frame a decree which would not affect any interest of the selling directors. For example, if an injunction which prohibited future violations were entered against only the appellees, the present defendants, this would have no effect upon the selling directors of Producers Life, and appellees have no standing to complain that the Commission may not have named as a defendant every person who may have been a party to appellees' scheme.

Upon remand the Commission could seek to amend its complaint to eliminate any relief to the extent that such relief might be deemed to affect the interests of the selling directors of Producers Life; or, if this Court should agree with the Commission that appellees' conduct constituted a scheme to defraud in violation of Rule 10b-5, the Commission could again seek to amend its complaint to include the selling directors of Producers Life. 12/

12/ The district court denied the Commission's motion to add the selling directors of Producers Life as defendants, stating:

> "[A]nd it appearing to the Court that, while there may be actionable claims against some of the proposed additional defendants for alleged breaches of fiduciary duty under the laws of Arizona, the Securities and Exchange Commission has not asserted, and cannot assert under any Federal statute which the Commission is charged with the duty to enforce, a cause of action against these proposed defendants [see: O'Neill v. Maytag, 339 F. 2d 76 (2nd Cir. 1964); Birnbaum v. Newport Steel Corp., 193 F. 2d 461 (2nd Cir. 1961)] . . . ." (R. 793-794.)

Should this Court find that the appellees' alleged conduct violated Rule 10b-5, the district court might wish to reconsider (continued)

CONCLUSION

For the foregoing reasons and for the reasons set forth in our opening brief, the judgment of the district court should be vacated and the case remanded to that court for further proceedings.

Respectfully submitted,

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March 1967

12/ (continued)

whether the conduct of their co-schemers was not also a violation of that provision. The doctrine of law of the case would not seem to preclude it from doing so. See Messenger v. Anderson, 225 U.S. 436, 444 (1912).

On the other hand, if the district court was correct in denying the motion to add the selling directors of Producers Life as defendants for the reasons it stated, then those persons are not indispensable parties.

CERTIFICATE

I certify that, in connection with the preparation of this brief, as corrected, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

David Ferber
Solicitor

April 5, 1967

APPENDIX

Portions of the Slip Opinion of the United States Court of Appeals for the Second Circuit in _Vine_ v. _Beneficial Finance Co._ (No. 30500, March 13, 1967)

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 67—September Term, 1966.

(Argued October 6, 1966 Decided March 13, 1967.)

Docket No. 30500

LEO VINE,

Plaintiff-Appellant,

—against—

BENEFICIAL FINANCE COMPANY, INC.,

Defendant-Appellee,

—and—

CHARLES H. DOWD, STUART A. WIXSON, GEORGE J. SPRINGER, C. H. DONOHUE and CROWN FINANCE COMPANY, INC.,

Defendants.

Before:

SMITH, HAYS and FEINBERG,

Circuit Judges.

Appeal from orders of the United States District Court for the Southern District of New York, Dudley B. Bonsal, *J.*, dismissing a complaint under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission, 252 F. Supp. 212, and denying leave to file a second amended complaint. The first order is reversed in part; the second is affirmed.

Lawrence M. Powers, New York, N. Y. (Berman & Powers, Ira W. Berman, on the brief), *for Plaintiff-Appellant.*

Wilkie Bushby, New York, N. Y. (Dewey, Ballantine, Bushby, Palmer & Wood, Joseph Schreiber, Robert I. Fisher, on the brief), *for Appellee.*

Philip A. Loomis, Jr., General Counsel; David Ferber, Solicitor; Roy Nerenberg, Attorney; Securities and Exchange Commission, Washington, D. C., as *amicus curiae,* urging reversal.

Feinberg, *Circuit Judge*:

This is another of the growing number of cases based upon section 10(b) of the Securities Exchange Act of 1934 ("the Act"), and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission. We deal primarily with the first amended complaint of appellant Leo Vine against appellee Beneficial Finance Company, Inc., which alleges violations of both the Act and state law. The District Court for the Southern District of New York dismissed the complaint. Its basic holding was narrow; the federal action failed because Vine was not a "seller" of securities. For reasons elaborated below, we hold that Vine is entitled to invoke the Act, and reverse the order of dismissal.

I.

The amended complaint alleges: Vine, a resident of New York, has owned during all relevant times 100 shares of Class A common stock of Crown Finance Company, Inc., a

Delaware corporation with its principal office in Delaware, as is Beneficial. Beneficial and Crown both are in the business of operating small loan offices. The stock of the former, with over a billion dollars in assets, is listed on the New York Stock Exchange; Crown, a much smaller company, has limited over-the-counter trading in its stock. Crown has two classes of common stock, A and B, with equal voting rights except that A designates one-third of the directors and B, two-thirds. In liquidation, a B share equals only one-tenth of an A share, and A has a claim on eighty per cent of sums set aside for payment of cash dividends at any time, while the B stockholders have twenty per cent. There were 624,870 A shares outstanding at the relevant times, and 46,500 B shares outstanding. The officers and directors of Crown were its principal Class B stockholders. Vine's claim is that Beneficial, acting in concert with these officers and directors and using means and instrumentalities of interstate commerce and the mails, defrauded Crown and its Class A stockholders by appropriating for Class B stockholders $900,000 which otherwise would have gone to Class A stockholders, and by merging Crown into Beneficial for at least $800,000 less than the fair market value of Crown.

The complaint describes the mechanics of the fraudulent scheme as follows: While negotiating for the acquisition of Crown in the spring and summer of 1963, Beneficial desired to merge Crown into Beneficial at a cost equal to Crown's book net worth, which in June was about $1,680,000, exclusive of good will. Knowing Beneficial's wishes in the matter, Crown's officers and directors[1] conspired with Beneficial to divert to themselves more than a fair share of the price to be paid for Crown. Although

1 Named as defendants, but only Beneficial was served.

these individuals were minority stockholders, they controlled the board of directors. If Beneficial had acted as it should have (according to Vine) and offered in a merger to give all Crown stockholders cash for their stock, or to buy Crown's assets for cash, A stockholders would have voted share for share alike with B stockholders. A's voting superiority would have prevented a merger or sale of assets giving grossly disproportionate proceeds to the B class, since either plan would require two-thirds approval of all stockholders. Even if the total price had remained the same, the Class A stockholders would then have received about $1,670,000, and Class B, only $12,500, the book value of the stock at the time. But using their fiduciary positions, the Class B stockholders "shape[d] the transaction in such a way" that they were paid about $700,000 for their shares, plus some $200,000 in benefits under employment and consulting agreements. Class A stockholders were paid only $800,000 for their stock, $870,000 less than they should have received. Moreover, but for the fraudulent scheme, Beneficial would have had to pay more than mere book net worth. Beneficial's motive in the conspiracy was to keep the cost of the acquisition down by overpaying the B's and underpaying the A's; Beneficial received at least $300,000 in tangible assets and $500,000 worth of going business value without paying for them.

In sum, in the words of the district judge, "the alleged fraudulent scheme involved three steps: (1) a purchase by Beneficial of the Class B stock from the directors of Crown; (2) a public offer or tender by Beneficial to the holders of the Class A stock to acquire 95% of the total outstanding shares of Crown; and (3) a short form merger of Crown into a wholly-owned New York subsidiary of

Beneficial which would result in the acquisition of the remaining shares of Class A stock." Thus, the complaint alleges that in early August 1963, Beneficial agreed with the principal B stockholders to buy their 43,000 shares at $15.00 a share, and later that month made a public offer to A stockholders to purchase A shares for $1.25 a share. This was increased to $2.50 in an offer sent out to remaining A holders in January 1965. Some A holders accepted, not knowing the facts. By the fall of 1965, having acquired ninety-five per cent of the A stock, Beneficial was engaged in completing the merger of Crown into it on a basis which paid minority stockholders $3.29 in cash per share; since this was a short form merger, the assent of the remaining A stockholders, like appellant Vine, was not necessary. The complaint further alleges that this overall scheme and the various acts and omissions pursuant thereto constituted fraud on the Class A stockholders and were violations of the Act and Rule 10b-5, and New York and Delaware law. The amended complaint seeks $1,700,000 in damages for Crown, plus what Crown's assets were worth in addition to what was paid for them, and punitive damages, all to be paid pro rata to A stockholders who did not participate in the claimed wrongdoing.

* * * * *

III.

Turning to the merits, we consider first the amended complaint's federal claim under the Act and Rule; the factual allegations in the complaint must, of course, be taken as true, since judgment was granted on a motion to dismiss. The district court's narrow holding was that since Vine neither accepted the offer to purchase his stock nor surrendered his stock pursuant to the statutory short form merger, he was not a seller, and therefore there could have been no fraud as to him in connection with the purchase or sale of a security.

Section 10 of the Act, 15 U. S. C. §78j, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national

securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 of the Commission, 17 C. F. R. §240.10b-5 (1964), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Although the complaint was properly characterized by the district judge as "diffuse," it does allege a "scheme . . . to defraud" and a "course of business which . . . would operate as a fraud" within subsections (a) and (c) of the Rule.[5] In this court, therefore, the narrow question is once again whether appellant is a seller, both parties assuming that *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (2d Cir.),

5 A violation of subsection (b) is also alleged in general terms.

cert. denied, 343 U. S. 956 (1952), requires this status for him.[6] Appellee claims that Vine is not a seller; appellant argues that he is indeed a seller, albeit a forced one, as a result of the short form merger.

Appellant's position is controlled by the mechanics of a short form merger. It is unclear whether the merger was carried out under Delaware or New York law, but the respective statutes are similar enough. New York Business Corporation Law §905(a) authorizes a corporation owning at least ninety-five per cent of the outstanding shares of each class of another corporation to merge the latter corporation into the former without the authorization of the shareholders of the latter corporation, on approval of the board of the former corporation (see §907(c) for foreign corporations). Under Delaware Code Ann. tit. 8, §253(a) (Supp. 1964), the surviving corporation need only own ninety per cent of the subsidiary. The consent of the remaining five per cent (or ten per cent) stockholders is not required to effectuate a short form merger. However, such stockholders are given an opportunity to obtain the fair value of their shares, either by agreement with the corporation (presumably this is the source of the $3.29 figure alleged by appellant) or by a judicial proceeding—the so-called "appraisal." See generally Israels, Corporate Practice 283-98 (1963); Note, *Valuation of Dissenters' Stock Under Appraisal Statutes,* 79 Harv. L. Rev. 1453 (1966).

Thus, once the conditions for a short form merger had been achieved, appellant's rights in his stock were frozen. He had and still has only the options of exchanging his stock for $3.29 a share, pursuant to appellee's offer, or pursuing his right of appraisal, which would also result in cash from appellee. Other than that, with one possible exception to be

6 An alternative suggestion of *amicus* Securities and Exchange Commission argues for a broader reading of the law, discussed below.

discussed below, appellant is left only with certificates of ownership in a non-existent corporation. Since, in order to realize any value for his stock, appellant must exchange the shares for money from appellee, as a practical matter appellant must eventually become a party to a "sale," as that term has always been used. See 1 Corbin, Contracts §4 (1963). It is true that appellant still has his stock; if he turned it in for the price of $3.29 a share, it would be clearer that appellant is a seller. Assuming that this would not otherwise affect his right to sue under the Act and the Rule, requiring him to do so as a condition to suit seems a needless formality.

We do not construe the Act so narrowly. As noted above, section 10(b) of the Act applies to the "purchase or sale" of securities. Section 3 of the Act, 15 U. S. C. §78c, provides:

> (a) When used in this title, unless the context otherwise requires—
>
> * * * * *
>
> (13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.
>
> (14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of.

It has been pointed out that the verb "include," rather than the verb "means," emphasizes the breadth of this definition, see *United States* v. *Robertson,* 181 F. Supp. 158, 162 (S. D. N. Y. 1959) (construing similar language in the Securities Act of 1933), and the phrases "or otherwise acquire" and "or otherwise dispose of" are hardly limiting. We do not have here a stockholder who refuses to accept a fraudulent offer to purchase his stock but remains a stockholder in an existing corporation; whether

to label this hypothetical person a "seller" under the Rule is a much different question. Due to defendant's acts, Crown has now disappeared and plaintiff's stock has, in effect, been involuntarily converted into a claim for cash. The only case cited to us on all fours is *Voege* v. *American Sumatra Tobacco Corp.,* 241 F. Supp. 369 (D. Del. 1965), in which the court concluded, although on a different theory from the one adopted here, that a short form merger brought about a fraud related to a "sale" of plaintiff's stock, even though she still physically possessed it. But see *Dasho* v. *Susquehanna Corp.,* 65 C 1757, N. D. Ill., June 28, 1966 (motion for rehearing), appeal pending, 7th Cir. We find no other case squarely in point, although *Ruckle* v. *Roto American Corp.,* 339 F. 2d 24 (2d Cir. 1964), and *Hooper* v. *Mountain States Sec. Corp.,* 282 F. 2d 195, 202-03 (5th Cir. 1960), cert. denied, 365 U. S. 814 (1961) ("otherwise dispose of"), both indicate receptivity on different facts to a broad construction of "sale" under the Act and Rule.[7] Although other cases are cited to us by appellees, none of them in fact is controlling.[8]

Under the particular circumstances of this case, we hold that appellant is a seller under the Act. Moreover the converse is, therefore, true; Beneficial, if the allegations

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7 See also *Polakoff* v. *Delaware Steeplechase & Race Ass'n,* 254 F. Supp. 574 (D. Del. 1966); *Simon* v. *New Haven Board & Carton Co.,* 250 F. Supp. 297 (D. Conn. 1966); *Eagle* v. *Horvath,* 241 F. Supp. 341 (S. D. N. Y. 1965); *H. L. Green Co.* v. *Childree,* 185 F. Supp. 95 (S. D. N. Y. 1960); *Blau* v. *Hodgkinson,* 100 F. Supp. 361 (S. D. N. Y. 1951); Fleischer, *"Federal Corporation Law": An Assessment,* 78 Harv. L. Rev. 1146, 1153 n. 37 (1965); 3 Loss, Securities Regulation 1469-71 (2d ed. 1961).

8 *E.g.,* there was no deception in *O'Neill* v. *Maytag,* 339 F. 2d 764 (2d Cir. 1964); in *Birnbaum* v. *Newport Steel Corp.,* 193 F. 2d 461 (2d Cir.), cert. denied, 343 U. S. 956 (1952), plaintiffs had not sold their stock and were not being forced to; *Barnett* v. *Anaconda Co.,* 238 F. Supp. 766 (S. D. N. Y. 1965), involved lack of causality between the deception and the injury.

of the complaint are accepted, is a purchaser of plaintiff's stock through its agent and wholly-owned subsidiary Beneficial Finance Company of New York, Inc. The *amicus* brief points out that the fraud alleged here is properly regarded as in connection with the purchase of the Class A stock, rather than a sale, since the wrongdoing emanates from the purchaser. We accept this characterization and note that it does not change the substance of the legal right involved.

Appellee vigorously contends that appellant cannot be a defrauded seller because nothing was asked of him, no representations were made to him—indeed, under the merger statute, nothing had to be communicated to him but notice of his right to the offered $3.29 or to demand an appraisal. But it is precisely because appellee gives no choice to Vine under the statute and the latter must now exchange his shares for cash that appellant can now be deemed a seller. But appellee says, assuming that conclusion of the merger makes appellant a seller, any deception was in connection with the earlier stock acquisition from the ninety or ninety-five per cent of A stockholders, and that deception did not relate to appellant, who did not sell at that time. This ignores the simple fact that appellant would never be in the position of a forced seller were it not for the fraud. In essence, because of the distinctive nature of the short form merger procedure, appellee by deceiving A can cause B to become a seller. When this is all part of a single fraudulent scheme and that scheme is a classic example of deception of an entire class of Class A public stockholders, as alleged here, we think the policies of section 10(b) and Rule 10b-5 justify holding that fraud on A is "in connection with" the forced sale by B. Appellee's point really is that reliance is a requirement in a Rule 10b-5 action and that appellant

could not have relied on any deception because no representation was made to him. The need for such reliance by a plaintiff has been the subject of much recent scholarly analysis. See, *e.g.*, Painter, *Insider Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5,* 65 Colum. L. Rev. 1361, 1366-72 (1965); Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity,* 74 Yale L. J. 658, 667-74 (1964). Whatever need there may be to show reliance in other situations, see *List* v. *Fashion Park, Inc.,* 340 F. 2d 457, 462-64 (2d Cir.), cert. denied, 382 U. S. 811 (1965); *Rogen* v. *Ilikon Corp.,* 361 F. 2d 260, 266-68 (1st Cir. 1966), we regard it as unnecessary in the limited instance when no volitional act is required and the result of a forced sale is exactly that intended by the wrongdoer. Since the complaint alleges that plaintiff, in effect, has been forced to divest himself of his stock and this is what defendants conspired to do, reliance by plaintiff on the claimed deception need not be shown. What must be shown is that there was deception which misled Class A stockholders and that this was in fact the cause of plaintiff's claimed injury. The allegations of this complaint meet that test.

The district court pointed out that the New York statutory scheme for short form mergers preserves appellant's right to challenge the legality of the merger.[9] N. Y. Bus. Corp. Law §623(k). Appellee claims this to be a misreading of the law; however, we need not tarry over this for we do not regard the existence of a state remedy as negating the federal right. See *J. I. Case Co.* v. *Borak,* 377 U. S.

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9 This is the possible exception to the description of appellant's rights referred to at pp. 1540-41 *supra;* appellee does not agree with the district court in this respect, arguing that "a short form merger in its nature cannot be attached by a minority stockholder as fraudulent."

426, 433-35 (1964). Appellee also points out that the *amicus* Securities and Exchange Commission has previously advocated that mergers do not result in sales of stock by dissenters.[10] We note that whatever stance it adopted two decades ago, the Commission strongly urges in this case that the short form merger resulted in a purchase and sale of plaintiff's stock within the meaning of Rule 10b-5.[11] Indeed, the Commission advances the alternative argument that plaintiff need not even be a selling stockholder to sue under 10b-5, so long as the Rule has been violated and plaintiff's stock lost value as a result. The Commission claims in effect that prior decisions in this circuit,[12] often cited for the rule that only a seller or purchaser may bring a Rule 10b-5 action, have been too broadly read and can be distinguished, see Leech, *Transactions in Corporate Control,* 104 U. Pa. L. Rev. 725, 832-35 (1956). In view of our disposition of this case, it is unnecessary to deal with this interesting contention. Finally, appellee argues that appellant can show no injury because the complaint alleges that the interest of the 624,870 outstanding shares of Class A stock amounted to $1,670,000 or $2.67 a share, while non-selling A stockholders were offered a minimum of $3.29 a share. However, the damages alleged to A stockholders do not rest solely on the $1,670,000 figure, but also include the sum of $800,000; this amounts not to less than $3.29 per A share, but to more.[13]

* * * * *

10 Reference is made to an *amicus* brief of the Commission in *National Supply Co.* v. *Leland Stanford Junior University,* 134 F. 2d 689 (9th Cir.), cert. denied, 320 U. S. 773 (1943), which construed the Securities Act of 1933.

11 Moreover, in *SEC* v. *National Sec., Inc.,* 252 F. Supp. 623 (D. Ariz. 1966), the Commission attacked a consolidation and reorganization under Rule 10b-5.

12 *Birnbaum* v. *Newport Steel Corp.,* 193 F. 2d 461 (2d Cir.), cert. denied, 343 U. S. 956 (1952); *O'Neill* v. *Maytag,* 339 F. 2d 764 (2d Cir. 1964); *List* v. *Fashion Park, Inc.,* 340 F. 2d 457 (2d Cir.), cert. denied, 382 U. S. 811 (1965).

13 It should also be pointed out that if appellant states a federal claim —as we hold he does—he also purports to represent those selling A stockholders who accepted the $1.25 per share public offer of August 1963, or the $2.50 public offer of January 1965, all of whom may have been injured, if the allegations of the complaint are true.

No. 21160

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Ceramic Tilers Supply, Inc., a corporation,

Appellant,

vs.

Tile Council of America, Inc., a corporation,

Appellee.

APPELLANT'S OPENING BRIEF.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Dictionary

Statutes

No. 21160

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Ceramic Tilers Supply, Inc., a corporation,

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Appellee.

APPELLANT'S OPENING BRIEF.

Jurisdictional Statement.

The action in the United States District Court, then for the Southern District of California, Central Division, was brought under the patent laws of the United States by the plaintiff-appellee, Title Council of America, Inc., charging infringement of United States Letters Patents 2,934,932 and 2,990,382 by defendant-appellant, Ceramic Tilers Supply, Inc., Jurisdiction in the District Court is founded upon Title 28 of the United States Code Section 1338(a) and Section 1400-(b). This Court has jurisdiction to review the judgment entered by the District Court, by virtue of Title 28 of the United States Code, Section 1291 and Section 1294. The Complaint [R. 2] sets forth the basis for the District Court's jurisdiction, and the Answer [R. 6] admits that the cause of action of the Complaint is laid under the Patent Laws of the United States. From the District Court's entry of judgment in favor of the plaintiff, the defendant appeals [R. 169].

Introduction.

An essential issue is the validity of patent rights covering mortar mixes that are useful for grouting and setting tile, laying masonry, stuccoing and plastering. The patented combinations of ingredients were described in prior patents in proportions within the ranges of the asserted claims. However, the claims do more-precisely specify certain ingredients *with regard to type and grade*. The particularly-specified ingredients perform the precise function accomplished by the identical "ungraded" ingredients of prior mortars.

> "Selection from among available materials of one material thought more suitable for a particular use is normally within the competence of the person of ordinary skill in the art, and, generally, is for that reason not patentable. Nothing is added to the sum of public knowledge when a known material is used to perform functions or produce results which could be reasonably foreseen from the material's known characteristics. As in the case of other combinations of ideas drawn from existing knowledge, the old elements, including the known material in the new use, must perform additional and different functions in the combination than out of it; the results must be unusual and surprising—."
>
> *Griffith Rubber Mills v. Hoffar* (9th Cir., 1963), 313 F. 2d 1, 3; 136 U.S.P.Q. 334, 337.

Statement of the Case.

This is an appeal from a suit charging the infringement of two patents covering mortar mixes (patents 2,934,932 and 2,990,382). The mortar mixes contain well-known dry ingredients that are simply stirred together, then combined with water to provide a workable mortar as for plastering, tile work, stucco and so on. Specifically, the essential ingredients of the patented mortars are:

> *cement,* as Portland and other hydraulic cements which harden by action with water [Tr. 340];
>
> *polyvinyl acetate,* a widely used substance well-known commercially as "Wilhold" glue [Tr. 422-423];
>
> *aggregate,* or inert cement additive, in the form of sand or limestone [Tr. 63];
>
> *Methylcellulose,* one of the cellulose gums commercially available from the Dow Chemical Company in the United States since the 1920's [Tr. 222-223].

Plaintiff-appellee, Tile Council of America, Inc., hereafter called the "Council", is a corporation organized to further the interests of American tile manufacturers [Tr. 28], and is supported by assessment of its members, who comprise a major portion of the tile manufacturers [Tr. 29] in this country. Defendant-appellant, Ceramic Tilers Supply, Inc., hereafter called simply "Tilers Supply", manufactures and sells various masonry supplies to the trade, including prepared, dry mortar mixes.

The Council accused Tilers Supply of producing several mortar mixes that infringed patents 2,934,932 and 2,990,382 [R. 2, Complaint]. Tilers Supply challenged the validity of both patents as lacking invention and also contended that none of the accused mortar mixes infringed either of the patents [R. 6, Answer].

The asserted claims are straightforward and simple. For example, the scope of asserted patent 2,934,932 is exemplified by Claim 1 thereof, which is comparable with exemplary prior art as follows:

Range of mortar mixes defined by Claim 1—Patent 2,934,932

Ingredient	Percentage by Weight
Portland cement	24.8 to 89.8%
methylcellulose (10 to 7000 CPS grade)	0.2 to 6.5%
sand or powdered limestone	10 to 75 %

Prior art recipe from Exhibit J (Spillmann patent) as interpreted by the Council's expert [Tr. 1381].

Ingredient		Percentage by Weight
Portland Cement		57.7%
methylcellulose		.3%
sand	15.4%	
chalk	17.3%	
	32.7%	32.7%

The other claims of patent 2,934,932 are directed to variations of mortar mixes and to processes of actually using the mortars to install tile.

The scope of the second patent 2,990,382 asserted in the suit is exemplified by Claim 1 thereof along with another chart of a prior-art recipe, as follows:

Range of mortar mixes defined by Claim 1 of Patent 2,990,382.

Ingredient	Weight in Relation to Percent of Cement
hydraulic cement	100 parts as a basis
methylcellulose (80 to 600 CPS grade)	0.25 to 6%
re-emulsifiable polyvinyl acetate	1 to 11%

Prior art recipe from Exhibit J (Spillmann patent) as interpreted by the Council's expert [Tr. 1382].

Ingredient	Weight in Relation to Percent of Cement
cement	100 parts as a basis
methylcellulose	.6%
polyvinyl acetate	5.9%

Other claims of the patent 2,990,382 are directed to variations of the mortar mix of Claim 1 and to the process of mixing dry, mortar ingredients preliminary to adding water.

Considering all differences, patent 2,934,932 claims a mortar mix in which one ingredient is *sand or powdered limestone.* As one possible point of difference, the prior art recipe [Ex. J] calls for *chalk* rather than the *limestone* of the patent claim. As one further technical point of difference, the claims of patent 2,990,382 specify that the polyvinyl acetate used in mortars thereof shall be "reemulsifiable", while the prior-art recipe [Ex. J] simply specifies "poly-

vinyl acetate". Physically, "*reemulsifiable* polyvinyl acetate" is a powdered form of the substance which when added to water is suspended forming a liquid, that in some applications is indistinguishable from liquid polyvinyl acetate [Tr. 815].

The claims of each patent also specify that the methylcellulose in the mortar mixes shall be within a certain range of grades. The claims of patent 2,934,932, for example, specify that the methylcellulose shall be between 10 to 7000 centipoise viscosity grade. As the prior-art recipe [Ex. J] does not specify the grade of methylcellulose to be used, another point of difference exists between the prior art and the patent.

This characteristic or grade of the methylcellulose relates to its ability to thicken water, and may be simply explained by considering an example. The addition of methylcellulose increases the viscosity of water, and as more is added, the mixture eventually becomes like molasses [Tr. 189-190]. As two-percent solutions are a standard, if two parts of *400 centipoise grade* methylcellulose is combined with 98 parts of water, the resulting solution is *400 times* as viscous or thick as water [Tr. 103].

The District Court did not consider these points of difference or even refer to the prior art of Exhibit J. Rather, in general the Court found significant differences between the patented mortar mixes and "conventional" mortar mixes which were in widespread use at the time the patents were applied for, and remain in widespread use. On that basis the Court held the patents valid [R. 137, Finds. 10-24].

The mortar mixes manufactured by Tilers Supply contained hydroxypropyl methylcellulose (or methyl-

hydroxypropyl-cellulose) rather than methylcellulose as specified in the patent claims [R. 88, Pre-Trial Order, Ex. 15]. Furthermore, some of the measured quantities in Tilers Supply mixes were slightly outside the limits defined by the patent claims. However, the District Court ruled that the mortars infringed certain of the claims, drawing support from a finding that Tilers Supply had copied its formulas from the Council [R. 143, Find. 33]. That finding is not supported by the evidence and therefore, *is in total dispute* in this appeal.

Tilers Supply also challenged the validity of patent 2,934,932 as having been procured as a result of false and misleading statements made to the United States Patent Office [R. 112, Pre-Trial Conference Order, Law Issue No. 6]. The District Court's opinion was totally silent on this most important issue of willful fraud on the Patent Office, although the statements are fully of record in the file history of patent 2,934,932, Exhibit AB.

1. Questions Presented.

The following basic questions are now before this Court:

1. Whether the "prior art" for determining the existence of an invention shall be conventional practices and materials in widespread use at the time when an alleged invention is made, or alternatively shall include all patents and printed publications existing more than one year prior to the time when the application is filed for a patent on the alleged invention.
2. Whether a patent for a combination of ingredients may be sustained as valid, on the basis

that the difference between the patented subject matter and the prior-art resides in specifying well-known grades of prior-art ingredients which accomplish no new or unexpected results.

3. Whether successful commercial exploitation by a patent owner, of products described in prior publications, is sufficient to uphold the validity of his patent.

4. Whether specifying: a "substance selected from the group consisting of sand and *limestone*" as one ingredient in a claimed mortar mix, patentably distinguishes a prior-art mix wherein that substance consists of nearly equal portions of sand and *chalk*.

5. Whether specifying: "methylcellulose of 10 to 7000 centipoise viscosity grade" as an ingredient in a claimed mortar mix patentably distinguishes a prior-art mortar mix simply calling for "methylcellulose".

6. Whether specifying: "reemulsifiable polyvinyl acetate" as an ingredient of a claimed mortar mix patentably distinguishes a prior art, mortar mix simply calling for "polyvinyl acetate".

7. Whether the doctrine of equivalents may be applied to broaden the scope of a patent monopoly to dominate mortar mixes containing a substitute ingredient, which mixes were described in publications prior to the patent.

8. Whether "hydroxypropyl methylcellulose" is the legal equivalent of methylcellulose in the mortar mixes claimed in United States Patents 2,934,-932 and 2,990,382 with respect to resolving questions of patent infringement.

9. Whether a patent is procured by intentional fraud if, in order to establish patentability, an applicant first tells the Patent Office that the alleged invention is novel because of the *omission of a certain ingredient*; then a year later the applicant tells the Patent Office that the alleged invention is novel by reason of the *inclusion of that identical ingredient.*
10. Whether the validity of a patent for a mortar mix can be sustained when the only difference between the patented mortar mix and a prior mortar mix is that, some of the prior-art mix ingredients are in different forms.
11. Whether or not the patent 2,934,932 is valid.
12. Whether or not the patent 2,990,382 is valid.
13. Whether or not any of the accused mortar mixes infringe patent 2,934,932.
14. Whether or not any of the accused mortar mixes infringe patent 2,990,382.
15. Whether there is any basis in law or in fact in this case for instructing a Master to recommend whether or not damages shall be increased.

2. False and Misleading Statements Issue.

Tilers Supply respectfully requests a definitive pronouncement by this Court (regardless of whether it reverses on other grounds or not) on the question of law presented below as to whether or not false and misleading statements were made to the Patent Office of the United States in the procurement of patent 2,934,932, as manifest in the prosecution file history [Ex. AB]. The question is the legal issue of whether the Council in the action below was enforcing the pat-

ent 2,934,932, with the knowledge that the patent had been fraudulently obtained by material misrepresentations of fact to the United States Patent Office. A definitive ruling on this issue of law [R. 111, Pre-Trial Conference Order, Issue of Law No. 6] is submitted as very significant to the final adjudication of this case, regardless of whether or not the patents herein are adjudged invalid on other grounds, or the accused mortar mixes are adjudged non-infringing.

Specification of Errors.

1. The District Court erred in upholding the validity of patents 2,934,932 and 2,990,382 by considering only *conventional* mortars and techniques as widely used in the tile industry as the prior art for the patents.

2. The District Court erred in relying to some degree on the doctrine of "commercial success" to hold patents 2,934,932 and 2,990,382 valid, when prior publications and patents clearly anticipate the patents in suit.

3. The District Court erred in relying on the Council's chemical patent expert to establish the standard for determining patentability rather than to consider the ability of a person having ordinary skill in the art to which the asserted patents 2,934,932 and 2,990,382 pertain.

4. The District Court erred in making an *unsupported* finding that Tilers Supply had copied from the Council.

5. The District Court erred in failing to find the existence of material misrepresentations to the

Patent Office amounting to fraud in the prosecution of patent 2,934,932, as clearly manifest in the prosecution file history of that patent.

6. The District Court erred in ruling that the specific cellulose gum, identified as "methylcellulose" is legally equivalent to the prior-art "hydroxypropyl methylcellulose" as used in mortar mixes.

7. The District Court erred in totally failing to recognize the accused mortar mixes as recipes of the prior art rather than mixes of the asserted patents 2,934,932 and 2,990,382.

8. The District Court erred in issuing an injunction on the basis of patents 2,934,932 and 2,-990,382 awarding costs to the Council, and granting damages.

9. The District Court erred in instructing a Master to recommend whether or not damages should be increased, as no evidence exists to support that instruction at law.

10. The District Court erred in finding either of the patents 2,934,932 or 2,990,382 valid.

11. The District Court erred in finding either of the patents 2,934,932 or 2,990,382 infringed.

Summary of Argument.

The only difference between the patented mortar mixes and recipes of the prior art, is that the patent claims specify certain ingredients to be of a *particular grade* or type. However, in each instance, the graded ingredient identified in the patent claims *performs the*

identical function that the ungraded ingredient performed in prior-art recipes. Therefore, the patented mortar mixes *totally lack invention* and the patents are invalid.

As an independent consideration, the file history of patent 2,934,932 establishes material misrepresentations of fact. Initially, the applicant stated, as a fact, that in a mortar for which the patent was being sought, the *presence of limestone or the like rendered the mortar unusable!* Later, before a different Examiner, the prosecution factually stated: *limestone is a necessary ingredient of the mortar!* As both contrary statements cannot be true, one of the factual statements is necessarily *false.* The statements were made before different Examiners at different times to distinguish different prior art and for the sole *purpose of procuring a patent.* Patents procured by false and misleading statements are invalid.

The mortar mixes of both patents include "methylcellulose" as one ingredient. None of the accused mortars include "methylcellulose". However, the accused mortars do contain an ingredient: hydroxypropyl methylcellulose, which ingredient was recognized for use in mortar recipes (with sand and cement) published well over one year prior to the applications for the patents in suit. The District Court found the ingredients "methylcellulose" and "hydroxypropyl methylcellulose" legal equivalents; however, the principle is universal that the "doctrine of equivalents" shall not be applied to recapture prior art within a patent monopoly. The accused mortars are not literally within the scope of the patents, nor can the patents properly be extended to encompass the accused mortars.

ARGUMENT.

1. Patent Number 2,934,392.

A. The Suit Patent 2,934,932 Is Anticipated by a Prior British Patent to Spillman [Ex. J].

Claim 1 of Patent 2,934,932 is exemplary of the claims and states:

> 1. A dry mortar composition adapted to be mixed with about 11 to 40% of its weight of water, which consists essentially of, by weight,
>
> 24.8 to 89.8% Portland cement, 0.2 to 6.5% methyl cellulose of *10 to 7000 centipoise viscosity grade* and about 10 to 75% of at least one substance selected from the group consisting of sand and powdered limestone. (Emphasis added)

The claim defines a dry mortar mix in clear and certain terms. As the claim is unambiguous, it is neither necessary nor permissible to resort to the specification. This principle is stated in *Graver Tank and Manufacturing Company, Inc. et al. v. The Linde Air Products Company*, 336 U.S. 271, 69 S. Ct. 535, 80 U.S.P.Q. 451, which has been followed by this Court in *Winslow Engineering Company v. Smith* (9th Cir. 1955), 106 U.S.P.Q. 209 and restated in *Beatty Safway Scaffold Company v. Uprights, Inc.* (9th Cir. 1962), 306 F. 2d 626, 134 U.S.P.Q. 379.

Considering the prior art that is applicable to the claim, the Court below viewed so-called "conventional" techniques, with respect to the patented mortar mixes. However, the applicable prior art is of much greater scope. Title 35 of the United States Code Section 102(b) specifically states one category of prior art

as patents of this or a *foreign country* existing more than one year prior to the date of an application for patent. A recent case states the patentee is:

> "charged with knowledge of all that prior art disclosed at time of his alleged invention, irrespective of whether persons of ordinary skill in the field, or he himself, or anyone else, actually possessed such all-encompassing familiarity with prior disclosures. Graham v. John Deere Co., 383 U.S. 1, 148 U.S.P.Q. 459 (1966); Griffith Rubber Mills v. Hoffar, 313 F.2d 1, 3, 136 U.S.P.Q. 334, 337 (9th Cir. 1963). This is so because the Constitution does 'not authorize the issuance of patents whose effects are to remove existent knowledge from the public domain, or to restrict free access to materials already available.' Graham v. John Deere Co." *Walker v. General Motors Corporation et al.* (C. A. 9, 1966), 362 F. 2d 56, 60; 149 U.S.P.Q. 472, 475.

Foreign patents issued prior to September 30, 1956 are clearly *prior art* to suit patent 2,934,932 and the disclosures therein are applicable to anticipate the patent. Such a patent is the British patent to Spillmann 743,952 [Ex. J] which discloses a mortar, *i.e.* a plaster, anticipatory of asserted patent 2,934,932. One mortar or plaster recipe from Exhibit J (interpreted by testimony quoted below) is as follows:

> "⅓ part by volume of a 30% aqueous suspension of finely divided polyvinylacetate which suspension is stabilized by added polyvinylalcohol, is mixed with ⅔ part by volume of a 1.5% aqueous solution of methylcellulose, whereafter 2 parts by volume of a mixture formed of 4 parts

by volume of Portland cement, 1 part by volume of lime, 1 part by volume of sand (or quartz) and 1 part by volume of pulverized chalk whiting is added. . . ."

The recipe as stated gives the ingredients *by volume* while the asserted Claim 1 specifies ingredients *by weight*. The conversion from volume to weight involves a rather simple calculation which the Council's patent expert performed. He then testified, stating the prior-art recipe of Exhibit J with the ingredients by weight, as follows:

> "Q. What are the results that you get? A. Well, I can read you the results which I get in weight per cent, which is, I believe, what is desired.
>
> Q. Yes. A. You wish me just to read the results, or to compare them with his?
>
> Q. Let's just take the results. A. I arrive at polyvinyl acetate 3.4 per cent, methyl cellulose .3 per cent, Portland cement 57.7 per cent, lime 5.9 per cent, sand 15.4 per cent, chalk 17.3 percent." [Tr. 1381]

The amounts of the ingredients Portland cement, methylcellulose, sand and chalk fall fully within the range specified by the patent claim. Only two possible questions of differences can exist:

(1) Is "chalk" essentially the same ingredient as "limestone"?

(2) Does a patentable distinction exist between "methylcellulose" and "methylcellulose of *10 to 7000 centipoise viscosity grade*"?

On the first question, testimony by the Council's expert established "chalk" to be a form of "limestone".

> "Q. As I understand your testimony, limestone may be more scientifically termed as calcium carbonate, is that correct, Dr. Lacey? A. Yes. Limestone is a naturally occurring form of calcium carbonate. It may have some impurities in it, as all natural products are likely to have. But essentially it is chemically calcium carbonate.
>
> Q. Now, as I understand it, chalk is also a form of calcium carbonate or limestone, is that correct? A. Yes. It is a form of calcium carbonate." [Tr. 288].

Thus, it is established that "limestone" (technically termed calcium carbonate) is generic to, and includes "chalk." *Chalk is limestone!* Therefore, the prior-art recipe of Exhibit J in specifying "chalk" as an ingredient squarely meets the "limestone" ingredient of the asserted claim 1.

On the second question, the asserted claim specifies methylcellulose that is of "10 to 7000 centipoise viscosity grade." The fact is that for many years all available methylcellulose fell in that grade range. The specified grade includes the entire range of grades that were available in the United States. The general designation of "methylcellulose" in Exhibit J therefore of necessity designated one of the available grades. This fact was established by the Council's expert, Dr. Wagner, as follows:

> "A. There is a 10-centipoise type. There is a 25-centipoise type. There is a 50-centipoise type. There is a 150-centipoise type; a 400-centipoise type; a

1,500-centipoise type; a 4,000; a 6,000; a 7,000; and more recently I think there have been introduced 13,000-centipoise types." [Tr. 106].

"Q. When did methyl cellulose first become commercially available in the United States, Dr. Wagner? A. I would have to make an estimate again there. It was first made by Dow, and, as I think we mentioned, Dow is the only producer. I believe Dow first started producing it somewhere in the 1920's, but this is just a rough estimate.

Q. Is it your testimony that methyl cellulose only recently became commercially available in the 13,000 centipoise grade and a 2 percent solution?

. . .

. . .

A. Well, on the solid material itself. I am sure that this became available at a much later date than the earlier low viscosity grades. I don't know the exact year when the 13,000 first did come, but it was considerably later.

On the 2 percent solution, any time that you have a water soluble methyl cellulose of any viscosity type you can make not only a 2 percent solution but a number of other solutions. So it would make no difference to the 2 percent solution whether it was 13,000 or 50 centipoise.

Q. What was the highest value viscosity grade that was available before the 13,000 came out, do you recall, Dr. Wagner? A. I think it was somewhere in the neighborhood of 8 or 9,000 centipoises.

> Q. And what was the lower limit available viscosities? A. The lower limit that I am aware of is a 10 or 15 centipoise methylcellulose." [Tr. 222-223].

This testimony, by the Council's expert establishes: that, for a period, the patent specified the entire range of available methylcellulose grades. Therefore, the grade specification was in fact meaningless to distinguish the prior art of Exhibit J. The teaching of the prior patent in specifying "methylcellulose" necessarily included one of the available grades. Therefore, the claim of the asserted patent is anticipated.

Only claims 1, 2, 5, 6, 7, 8, 9 and 10 of the asserted patent 2,934,932 have been held valid and infringed. However, all of the claims 1 through 8 have been summarized in a chart below for easy comparison with the prior art recipe of Exhibit J.

The chart illustrates that the prior-art recipe [Ex. J] falls fully within the scope of each of the ingredient ranges specified in Claims 1, 2, 4, 6, 7 and 8. Of the other claims, claim 3 has not been adjudged valid and infringed; however, claim 5 has been so held. The distinction between claim 5 and the prior-art recipe is a deviation of a 4.6% in the required quantity of sand. The inclusion of this slight additional amount of sand would be obvious to one skilled in the art and is in no manner critical to the formula. Claims 8, 9 and 10 are also here on appeal; however, these claims are directed to the process of setting tile with the mortar of claim 8.

> Q. And what was the lower limit available viscosities? A. The lower limit that I am aware of is a 10 or 15 centipoise methylcellulose." [Tr. 222-223].

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Claims of Patent 2,934,932

	Recipe of Ex. J	Claim 1	Claim 2	Claim 3	Claim 4	Claim 5	Claim 6	Claim 7	Claim 8
Portland cement	57.7%	24.8-89.8%	49.8-79.8%	64.8-79.8%	39.8-89.9%	39.8-89.9%	49.8-89.8%	49.8-89.8%	24.8-89.8%
Methylcellulose	.3%	.2-6.5%	.2-6.5%	.2-6.5%	.2-6.5%	.2-6.5%	.2-6.5%	.2-6.5%	.2-6.5%
Sand	15.4%					20-50%		10-35%	
Limestone	17.3%						10-50%		
Total of Sand & Limestone	32.7%	10-75%	20-50%	20-35%	10-50%				10-75%

Recapitulating, the claims 1, 2, 5, 6, 7, 8, 9 and 10 of patent 2,934,932 are here on appeal. Of these, claims 1, 2, 6 and 7 are clearly directly anticipated under 35 U.S.C. 102(b).

> "A person shall be entitled to a patent unless—
>
> (b) the invention was *patented* or described in a printed publication in this or a *foreign country* . . ., more than one year prior to the date of the application for patent in the United States. . . ." (Emphasis added.)

The asserted claim 5 specifies a mortar that is at least 20% sand while the prior-art recipe [Ex. J] calls for only 15.4% sand. Neither the patent nor the record suggests any unexpected, unusual or new characteristics that would result from increasing the sand content from 15.4% to 20%. It is well established that rearranging portions of particular ingredients (even to produce a variance in properties) is not inventive unless new characteristics result. *Coast Metals, Inc. v. Wall Colmonoy Corp.* (9th Cir. 1963) 315 F. 2d 416, 137 U.S.P.Q. 201; *Brunswick Corporation v. Columbia Industries, Inc.* (9th Cir. 1966), 362 F 2d 172, 150 U.S.P.Q. 83. The widespread practice of using sand in cement mortars, and varying the quantities in accordance with different job requirements renders a non-critical variation of 4.6% in the sand of a mortar far, far below the established standard of invention. Claim 5 of the patent must fall as invalid along with claims 1, 2, 6 and 7.

B. The Method Claims of Patent 2,934,932 Are Invalid Because No Novel Method Steps Are Recited.

Claims 8, 9 and 10 of patent 2,934,932 are directed to a process for installing ceramic tile. The particular process employs the mortar of Claim 1 with tiles and includes the steps of:

1. covering a substrate with a bed of the mortar; and
2. pressing dry tile into the bed.

Claim 9 of the patent is more explicit and defines that the mortar bed shall be between "1/16th and ¼" thick. Claim 10 of the patent is also more specific and recites an additional step of placing a thin coat of the mortar on the back surfaces of the tile, prior to setting in the bed. These process steps in setting tile are old and well known in the prior art. Specifically, the process steps recited in claims 8, 9 and 10 were described in a publication sold by the Council and copyrighted in 1952, entitled "Genuine Clay Tile" [Ex. Y]. Furthermore, the Council established the process steps as prior art in admitted facts 38, 39 and 40 of the Pre-Trial Conference Order [R. 93]. Specifically,

"38. The process of installing ceramic tile, which comprises covering a substrate with a bed of paste substance and pressing dry tile into said bed, was known or used by others in this country prior to 1956.

39. The process of installing ceramic tile, which comprises covering a substrate with a bed of paste substance to a thickness between about 1/16 and ¼" thick, and pressing dry tile

into said bed, was known and used by others in this country prior to 1956.

40. The process of installing ceramic tile, which comprises covering a substrate with a bed of paste substance, giving the back surfaces of the tile a thin coat of said substance, and pressing the tile into said bed was known and used by others in this country prior to 1956."

The absence of novel process steps strips a process claim of novelty and validity. As restated in *Kemart Corporation v. Printing Arts Research Laboratories, Inc.* (9th Cir. 1953), 201 F. 2d 624, 629, 96 U.S.P.Q. 159,

> "The test of identity of processes (*in determining novelty*) is not the apparatus used for carrying them out but whether they involve identical or equivalent steps." (Italics added) *Celite Corporation v. Dicalite Co.* (9th Cir. 1938), 96 F. 2d 242, 248.

Indeed, to hold otherwise would result in a myriad of patents monopolizing all the processes in which a new composition of matter could be used. For example, the development of powdered re-emulsifiable milk would have opened the doors to opportunists to patent the steps of every worthwhile food-processing technique in which liquid milk had been used as an ingredient. Bakers, for example, would then find they could not substitute powdered milk in a recipe hundreds of years old, though the powdered milk was invented as a substitute. Similarly, the development of a new cement would stimulate freeloaders to patent the process of using that cement to lay bricks, to set tile, to build

concrete structures, and on and on. Clearly, patent protection cannot be awarded to all who jump to apply a newly-developed material to its intended uses. The creation in these situations lies in the new ingredients, not in applying the ingredients to prior processes.

The argument in the last-preceding paragraph has considered claims 8, 9 and 10 as though they recited a *new material*, used in an old process. Such claims would not be patentable. However, in fact, these claims *do not even include a new material!* The mortar recited in the claims is clearly disclosed in the Spillmann patent, as considered. Thus, the claims define an old process employing an old material. The public cost of monopoly for the claimed processes cannot be justified. The claims are invalid in law and in all public interests.

C. Commercial Success Cannot Sustain the Validity of Patent 2,934,932 in View of the Total Anticipation.

A large measure of the evidence presented during the trial of this case was directed to the question of commercial success, and was asserted with the objective of supporting the validity of the patent 2,934,932. However, that evidence is *totally immaterial* in view of the complete anticipation of the mortar mixes by prior art references, *Farr v. American Air Filter Company, Inc.* (9th Cir. 1963), 318 F. 2d 500, 137 U.S.P.Q. 627. The evidence should not have been considered. It does not merit further consideration. In evaluation, peripheral considerations cannot support a patent lacking a basis of invention. A recent case considers the

> ". . . presumption of validity arising from the issuance of the patent, commercial success, copy-

ing, and market demand. The law appears to be clear that such factors cannot make patentable a patent which is invalid for lack of invention." (citing Graham et al. v. John Deere Co. et al. (1966) 383 U.S. 1), *Brunswick Corporation v. Columbia Industries, Inc.* (C.A. 9, 1966), 362 F. 2d 172, 175, 150 U.S.P.Q. 83.

D. The Patent 2,934,932 Was Procured by False and Misleading Statements to the Patent Office Documented by the File History.

The Council has urged that the presumption of validity attendant issued patents should be supported in view of the prior art cited by the Patent Office. The Spillmann patent [Ex. J] applied above as primary prior art was not considered by the Patent Office Examiner in the prosecution of United States Patent 2,934,932. In those instances where such an anticipatory reference is not before the Patent Office during the examination period, any remaining shadow of the presumption of validity is dissipated. *Rohr Aircraft Corporation, et al. v. Rubber Teck, Inc. et al.* (9th Cir. 1959), 266 F. 2d 613, 121 U.S.P.Q. 241.

Although the Spillmann patent [Ex. J] was not cited in the prosecution of patent 2,934,932, it is recognized that a very pertinent reference, patent 2,700,-615 to Heijmer [United States equivalent of British patent 696,965, Ex. B] was considered in the prosecution of this patent. The Heijmer patent [Ex. B] discloses a recipe of ingredients which falls within the scope of the patent in suit. This fact was established by the Council's expert [Tr. 1375].

An explanatory basis for the fact that the patent did issue, is provided by the false and misleading

statements made to the Patent Office to distinguish the prior references. These statements are of record, completely documented in the patent prosecution file history [Ex. AB]. A patent is invalid if false and misleading statements are asserted to the Patent Office in the procurement thereof. *Precision Instrument Manufacturing Company v. Automotive Maintenance Machinery Company,* 324 U.S. 806 (1945), 65 U.S.P.Q. 133; *Hazel-Atlas Glass Company v. Hartford-Empire Company,* 322 U.S. 238, 61 U.S.P.Q. 241 (1944).

During the prosecution of the suit patent 2,934,932 the prior patent 2,700,615, Heijmer [Ex. B] was cited by the Examiner as a ground for initially rejecting the claims. The Heijmer patent discloses the ingredients: Portland cement, sand, and methylcellulose in combination as a mortar. In fact, with a single ingredient modification, as taught by the patent itself, one exemplary recipe of the Heijmer patent clearly falls within the range of the suit patent, as stated in testimony (quoted below) by the Council's patent expert.

The Heijmer patent discloses the use of both "methylcellulose" and another cellulose ether, "ethylcellulose" in cementitious mortars. Specifically, the Heijmer patent states:

> "Suitable cellulose derivatives for use in connection with the invention may be selected from a group consisting of water-soluble methyl or ethylcellulose and water-soluable salts of celluloseglycolate." [Ex. B, col. 1].

The patent then proceeds to give two exemplary recipes, one of which falls within the range of the suit patent as stated by the Council's patent expert:

> ". . . If you are asking me, if *methyl cellulose* were to be placed here in place of *ethyl cellulose,* then I would say that this composition falls within the range of compositions given in the '932 patent." [Tr. 1376] (Emphasis added).

Facing the formidable teachings of the Heijmer reference, in prosecuting their patent, the Council eliminated recitations of "chalk" and "limestone" from the claims then being urged, and argued:

> "Heijmer's plaster *must contain chalk* and may also contain pumice. They are not intended as mortars for setting tile or masonry and are not usable as such." (Emphasis added) [Ex. AB, p. 25, line 24].

The record indicates that the Patent Office accepted this distinction and searched for disclosures of prior mortars including: Portland cement and methylcellulose, *but* with no limestone or other aggregate.

The Patent Office located such mortar recipes and the Council then faced the burden of distinguishing such prior art. At this stage of the prosecution, the Heijmer patent was in the background, the case had been transferred to another Examiner, and the mortar recipe that now had to be distinguished did *not* include sand or limestone. Under these circumstances, the Council totally reversed their position, now stating that sand or *limestone was a necessary ingredient* of the mor-

tar. These ingredients were added to the claims, distinguishing the current references under the factual assertion:

> "the claims remaining in the present application all recite sand or limestone, the ingredient *necessary* for mortar." [Ex. AB, p. 35, line 22].

The two-time separated assertions are conflicting statements of fact, specifically:

(1) the mortar (for which a patent is sought) *is not usable if it contains chalk!*

(2) The mortar (for which a patent is sought) *must include sand or limestone!*

The Council's expert established the identity of "chalk" and "limestone". [Tr. 288]. As the two arguments are diametrically opposed, one is necessarily *false* and was asserted for the purpose of obtaining a patent. False and misleading statements were made to the Patent Office to secure the asserted patent 2,934,932. *A ruling to that effect is respectfully requested!*

2. Patent Number 2,990,382.

A. The Suit Patent 2,990,382 Is Anticipated by Prior Patents.

Claim 1 of patent 2,990,382 is somewhat representative, and states:

> "A composition capable of being mixed with water to form a mortar and comprising a hydraulic cement as its principle ingredient and the following ingredients in percentages based on the weight of the cement:
>
> methylcellulose having a viscosity between about 80 and 6000 centipoise in 2% solution, about 0.252 to 6% and re-emulsifiable polyvinyl acetate, about 1 to 11%."

The term "emulsion" is defined in Webster's *Third New International Dictionary* (1961) as "an intimate mixture consisting of a semi-solid or solid (as a resinuous or bituminous material) dispersed in a liquid."

"Re-emulsifiable" as used in the claim describes a powder which, on being added to water, becomes suspended or dispersed to provide an emulsion. The process for producing the powder is described by its inventor in U. S. Patent 2,800,463 [Ex. G]. The simple basic question in considering invalidity of the asserted patent is: whether or not using the newly-developed, dry or powdered form (re-emulsifiable) of polyvinyl acetate in a mortar mix is a patentable distinction over using liquid polyvinyl acetate in which the small particles are carried in water. This question was considered by the Patent Office and initially answered in the negative:

> "The primary reference prepares compositions comprising Portland Cement, sand, methylcellulose and a polyvinyl acetate emulsion. To utilize a spray dried emulsion in place of the emulsion of the primary reference would not amount to invention in view of Robinson." [Ex. ZZ, p. 19].

"The primary reference" referred to by the Examiner is an Australian Spillmann patent 166,556, which is the equivalent of the English Spillmann patent [Ex. J] considered previously herein. The natural query arises: why, then, did the Patent Office deviate from their position and grant the patent?

As evident from the prosecution file history of the patent [Ex. ZZ], it was granted because the Patent Office lost sight of the "primary reference."

Preliminary to analyzing the file history, it is worth while to consider further the term "re-emulsifiable poly-vinyl acetate." In the manufacturing of the milky-white poly-vinyl acetate (recognized as the widely-used white Wilhold glue), exceedingly-minute droplets are produced as tiny solid particles suspended in a liquid emulsion [Tr. 817]. That form of the glue or emulsion is often used; however, for convenience in storing, transporting and using the substance, it can be converted into a powder by spray drying in accordance with the process disclosed in U. S. Patent 2,800,463 [Ex. G]. The reasons for converting the liquid polyvinyl acetate material into a powder (re-emulsifiable) are precisely the same as the reasons for converting liquid milk into a dry powder; *i.e.,* storage, shipping, and so on. The alleged invention of the asserted patent resides merely in substituting the newly-discovered (by another) *powder* polyvinyl acetate (rather than the previously well-known liquid form) in an old mortar mix with no change in function or result.

The claimed development is analogous to substituting powdered milk as a coffee whitener in place of liquid milk. It clearly falls far short of the standard of invention requisite to support a patent. Hundreds of persons (not skilled in any art) undoubtedly tried powdered milk in their coffee immediately upon its availability. The substitution in mortar mixes of newly-available dry polyvinyl acetate for the liquid form was fully as obvious to persons long accustomed to using liquid polyvinyl acetate in cementitious mortars. In fact

the use is contemplated by patent 2,800,463 [Ex. G] which was granted on the process for making powdered (re-emulsifiable) polyvinyl acetate as follows:

> "As will be evident to persons skilled in the art, my powdered product can be utilized in various other ways in which powdered resins have heretofore been employed. Thus, the powdered resin can be mixed with various other types of resins; and also with fillers, extenders, plasticizers, etc., to adapt it for use for particular purposes." (Column 4, line 68).

The mortar covered by the asserted patent (including the powder polyvinyl acetate) involves a mere change of material, pure and simple. A patent for such a feeble and non-inventive development is invalid. *Great Atlantic & Pacific Tea Company v. Super Market Equipment Corporation,* 340 U.S. 147, 71 S. Ct. 127, 84 U.S.P.Q. 209; *Dresser Industries, Inc. v. Smith-Blair, Inc.* (9th Cir. 1963), 322 P. 2d 878, 139 U.S.P.Q. 1; *Graham et al. v. John Deere Company et al.* (1966), 383 U.S. 1, 148 U.S.P.Q. 459.

A relatively-recent opinion of this Court effectively summarizes the instant situation:

> "It is not necessary to delve deeply into this refinement to perceive that, in any event, the advance is one in degree rather than in kind. And that plainly is not enough to constitute a patentable advance. For Lincoln Engineering Co. v. Stewart Warner Corporation, 303 U.S. 545, 549-550, 337 USPQ 3 (1938) teaches us that * * *

> the improvement of one part of an old combination gives no right to claim that improvement in combination with other old parts which perform no new function in the combination." *The Troy Company v. Products Research Company* (9th Cir. 1964), 339 F. 2d 364, 367; 144 U.S.P.Q. 51.

The action by the Patent Office in granting patent 2,990,382 in view of the Spillmann reference is offered below merely as an explanation. Initially, the Patent Office's position was summarized:

> "To utilize a spray dried emulsion in place of the emulsion of the primary reference would not amount to invention. . . ." [Ex. ZZ, p. 19.]

Thereafter, the Council asserted that the primary reference (Spillmann Australian Patent) is directed to a *paint* rather than a *mortar or plaster*. Specifically, the following statement was made to the Patent Office:

> "The subject matter both of Robinson and the Australian patent is that of waterbased cement paints." [Ex. ZZ, p. 22].

Actually, the Spillmann patent provides two specific recipes. The first is directed to a paint. However, the second recipe is a *mortar* for use in plastering and falls precisely within the claims of the patent in question.

The patent file history indicates the contention that the Spillmann patent discloses a paint (rather than plaster or mortar) was eventually successful to procure the patent. Specifically, after unsuccessful amendments, the Council filed *four* requests for reconsideration, then appealed the patent application and filed a

brief. The appeal was never decided. Rather, from the history, after an informal negotiation, the appeal was dismissed and the patent was granted. The Patent Office erred in granting the patent and the presumption of validity cannot be supported. Patent 2,990,382 is clearly invalid.

B. The Method Claims of Patent 2,990,382 Are Invalid Because No Novel Method Steps Are Recited.

The process or method claims 7, 8, 9 and 10 of patent 2,990,382 are directed to combining dry ingredients before adding water. The claimed development is analogous to stirring together powdered or instant coffee, sugar and powdered milk before adding hot water. The existence of a patent on such a method or process is completely untenable.

Admitted fact 41 of the Pre-Trial Conference Order states:

> "The process of manufacturing a composition capable of being used with water to form a mortar composition, comprising mixing ingredients in a dry state, was known and used by others in this country prior to 1956."

The identical law invalidating the process claims of the other suit patent (2,934,932) is applicable to these claims. The process is: mixing dry ingredients! The process is void of invention; the claims defining the process are invalid.

Specifically, representative claim 7 of patent 2,990,-382 states:

> "7. The method of manufacturing a composition capable of being mixed with water to form a mortar composition, comprising mixing in the

> dry state, a hydraulic cement, methyl cellulose having a viscosity between 80 and 6000 centipoises in 2% solution in an amount from about 0.25 to about 6% by weight of the hydraulic cement, and reemulsifiable polyvinyl acetate in an amount from about 1 to about 11% by weight of the hydraulic cement."

If the specific materials are replaced in the claim by several dry materials, the claim simply becomes:

> The method of manufacturing a composition capable of being mixed with water to form a mortar composition, comprising mixing in a dry state several dry materials.

Stripped to the actual process which it covers, by the elimination of particular materials or apparatus, the claim lies clearly within the scope of prior art as admitted by the Council. A process patent on the process of merely combining dry ingredients cannot be sustained as valid.

3. The Accused Products.

A. The Accused Products Do Not Infringe the Claims of Either Patent Because the Products Are From the Prior Art.

None of the accused products contain methylcellulose. Rather they contain Dow Chemical Company's "Methocel HG," (hydroxypropyl methylcellulose). Therefore none of the accused mortar mixes literally infringe either of the patents because *all* the claims recite "methylcellulose" as a necessary ingredient. The claims alone provide the standard against which infringement is to be determined in the first instance. *Nelson v. Batson* (9th Cir. 1963), 322 F. 2d 132, 138 U.S.P.Q. 552.

In the absence of literal infringement of claims, the question of equivalents must be considered. The degree to which a patent monopoly can be expanded by the doctrine of equivalents has been the subject of considerable judicial consideration. The determination may be made by considering *the state of the prior art,* the significance of any contribution of the claimed invention and the similarity between the claimed and the substituted ingredients. *Moon et al. v. Cabot Shops, Inc. et al.* (9th Cir. 1959), 270 F. 2d 539, 543, 123 U.S.P.Q. 60.

In the present situation, the prior art *conclusively resolves against applying the doctrine of equivalents.* The particular cellulose ether (hydroxypropyl methylcellulose) used in the accused mortar mixes was proposed for use in mortars *long prior* to the suit patents. The doctrine of equivalents cannot expand the suit patents to include the accused mortar mixes which have clear antecedent in prior patented art. *Air Devices, Inc. v. Air Factors, Inc. et al.* (9th Cir. 1954), 210 F. 2d 481, 100 U.S.P.Q. 296.

A United States patent 2,629,667, Kaveler [Ex. P] is prior to either of the suit patents and discloses a recipe for a mortar including: aggregate, Portland cement, and a particular type of cellulose ether. The following testimony establishes that the particular cellulose ether specified in the Kaveler patent [Ex. P] coincides with the cellulose ether hydroxypropyl methylcellulose (identified by the Dow Chemical Company designation "Methocel HG") employed in the accused mortar mixes.

> "Q. Are you familiar with the Dow Chemical Methocel products, Dr. Stone? A. Yes.

> Q. Are you familiar with the Dow Chemical products which are marketed under the trade name Methocel HG? A. Yes, I am.
>
> Q. How does the cellulose ether which you have described, as taught in the patent, Exhibit P, and explained on Exhibit BJ for identification, compare with the Dow Methocel HG? A. The Methocel HG products are *mixed ethers* of cellulose, methyl hydroxypropyl, and, based on my reading of this, they would be encompassed within this patent. They are specifically mentioned in column 3, line 68:
>
> 'Compounds covered are methyl, ethyl or propyl, hydroxyethyl, hydroxypropyl or hydroxybutyl cellulose mixed ethers.' And *these would fall under the methyl hydroxypropyl mixed ethers.*" (Emphasis added.) [Tr. 789].

This unchallenged statement by an unchallenged expert appears conclusive. However, the testimony continues, emphasizing the identity of the cellulose ethers of the Kaveler patent and the ingredient employed by Tilers Supply.

> THE WITNESS: Let me see if I can clarify it, your Honor.
>
> He asked me about the Dow Methocel HG products.
>
> THE COURT: Yes.
>
> THE WITNESS: These are a group of products that are designated Methocel HG by the Dow Chemical Company.
>
> THE COURT: What are those products?
>
> THE WITNESS: Those products are all mixed ethers of cellulose. They are methyl hydroxypropyl cellulose ethers.

THE COURT: *Methyl hydroxypropyl ethers* are described on page 3, or are mentioned on page 3 of the Kaveler patent—column 3 of the Kaveler patent.

THE WITNESS: Right.

THE COURT: What is the substitution of the Dow Chemical HG product?

THE WITNESS: The substitution varies depending — this is how they designate different grades. The substitution, generally, the methyl substitution, is a DS level of something between 1 and perhaps 2—broad range.

THE COURT: The degree of substitution?

THE WITNESS: Pardon?

THE COURT: The degree of substitution, when you refer to 1 to 2?

THE WITNESS: This goes back to the number of methyl groups. When we say 1, this means approximately 33 per cent of the available hydroxyl groups are substituted with methyl; a DS of 2, approximately 67 per cent are substituted with methyl. The methyl substitution in the Dow products is in that general range. And the hydroxypropyl substitution is somewhat less than that, being anywhere from, say, 1 or 2 up to about 10 or possibly 15 per cent of the hydroxyl groups—

THE COURT: Well, the Dow product degree of substitution is 1 to 2 of the methyl?

THE WITNESS: Right.

THE COURT: And what is the rest of it?

THE WITNESS: The hydroxypropyl substitution is somewhere between 1/10 or lower, and, say 3/10ths.

THE COURT: Then that would be, instead of 1 to 3, it would be .1 to .3?

THE WITNESS: .3.

THE COURT: Proceed.

BY MR. NILSSON:

Q. *Are those degrees of substitution within the range as specified in the Kaveler patent,* Dr. Stone? A. *They are.*

Q. I believe you used the term—we have used both the terms methyl hydroxypropyl cellulose and hydroxypropyl methyl cellulose. Would you clarify that, if there is any distinction there? A. No. I will try to clarify it. There is no distinction. In general, good nomenclature calls for naming the simplest group first. *So we say methyl ethyl cellulose or methyl hydroxypropyl cellulose.* But chemists are careless and flip these back and forth. But I think any other chemist would understand if somebody said methyl hydroxypropyl cellulose instead of hydroxypropyl methyl cellulose. It is also *the same material.*

Q. *Dr. Stone, does the Kaveler patent teach the use of this form of a cellulose ether in a mixture of cement and sand?* A. *It does.*

(Emphasis added). [Tr. 790-793].

The above testimonial passages clearly establish that Dow "Methocel HG" (as used in the accused products) is a mixed ether, not only distinctly different chemically from methylcellulose (a simple ether) but more significantly, as an ingredient of mortar mixes including sand and Portland cement *which were patented long prior* to the time of the patents here in suit.

The testimony of the unchallenged expert, Dr. Stone, establishes the fact. However, an independent,

detailed documentation of the prior teaching is also set forth below (in summary form).

The Kaveler patent 2,629,667 [Ex. P] discloses a mix "useful in grouting in general" (column 2, line 8) which is precisely the class of mortars covered by the asserted patents (patent 2,934,932 column 1, line 3). Manufacture of the accused products is effectively described in the Kaveler patent [Ex. P] by the following statement:

> "In preparing the slurry the dry ingredients comprising hydraulic *cement*, with or without the usual additives, the inert filler material, such as *sand or crushed limestone*, and the alkyl hydroxyalkyl *cellulose mixed ethers* where the alkyl group contains 1 to 4 carbon atoms and the hydroxyalkyl group contains 2 to 4 carbon atoms may be mixed together and later mixed with water, . . ." (Emphasis added.) [Ex. P, column 2, line 19].

In analyzing the above quotation, an initial question is: whether or not "hydraulic cement" includes Portland cement as used in the accused products. This question is resolved in the affirmative by another statement from the prior patent:

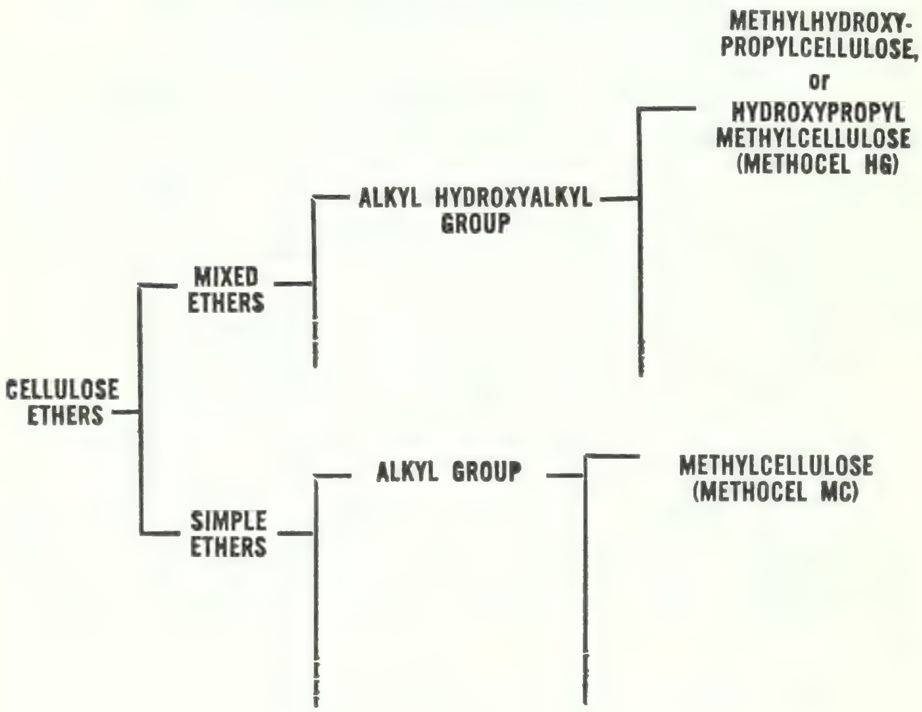
> "Hydraulic cements include hydraulic lines (*sic*), grappier cements, puzzalan cements, natural cements, and Portland cements." [Ex. P, column 2].

In this manner, Exhibit P clearly teaches the use of Portland cement, sand and crushed limestone with the addition of a particular type of cellulose ether, *i.e.*

> "alkyl hydroxyalkyl cellulose mixed ethers where the alkyl group contains 1 to 4 carbon atoms and the hydroxyalkyl group contains 2 to 4 carbon atoms, . . ." [Ex. P, column 1].

The patent states the quantity of the cellulose ether shall be between 0.05% to 5% but preferably about 1% by weight of the weight of the dry cement [Ex. P, column 1, line 54]. That amount is precisely within the range specified in each of the suit patent claims as well as covering the accused products.

The only remaining question is: whether or not the cellulose ethers specified in Exhibit P include the same specific cellulose ether, employed in the accused products (identified by the trademark "Methocel HG", manufactured by the Dow Chemical Company)? This was established by testimony of Dr. Stone (quoted above) and also by Dow people in deposition testimony. The following classification chart may afford some help in considering the evidence pertinent to these cellulose ethers.



Initially, the basic distinction between the Dow products "Methocel MC" (methylcellulose) and "Methocel HG" (hydroxypropyl methylcellulose) is borne out by testimony of a Dow Chemical Company executive, Mr. Richard Swinehart, who among other activities at the Dow Chemical Company has been the Director of Research of the Cellulose Laboratory and Superintendent of Manufacture of Methocel. His deposition testimony was:

> "Q. Are you familiar with products manufactured and sold by the Dow Chemical Company designated by the trademark Methocel and specifically its designation, Methocel MC and Methocel HG? A. I am.
>
> Q. What is the chemical name of the product Methocel MC? A. Methylcellulose.
>
> Q. What is the chemical name of the product Methocel HG? A. It is methylhydroxypropylcellulose." [Ex. AE, p. 5]. * * *
>
> "Q. Now, you state whether or not methylcellulose and hydroxypropylmethylcellulose belong to different chemical groups? A. They are different chemically.
>
> Q. Do they belong to different chemical groups? Are you familiar with the chemical group alkyl cellulose? A. They are different in regard to this term, yes.
>
> Q. Would you explain to me how they are different? A. Well, the alkyl group—methylcellulose belongs to the alkylcellulose grouping and the hydroxypropylmethyl belong to the alkylhydroxy alkyl groupings, by this reference." [Ex. AE, p. 11].

This testimony thus states the difference between "Methocel HG" and "Methocel MC", and establishes "Methocel HG" as hydroxypropyl methylcellulose or as it is sometimes referred to, methylhydroxypropylcellulose (with the component word parts rearranged). The testimony also establishes the "Methocel HG" (used in the accused products) as an alkyl hydroxyalkyl cellulose as identified in Exhibit P.

The only question remaining is whether or not the Dow Methocel HG cellulose ether (used in the accused product) is, as specified in the prior patent [Ex. P] a,

> "mixed ether where the alkyl group contains 1 to 4 carbon atoms and the hydroxyalkyl group contains 2 to 4 carbon atoms."

Referring again to Mr. Swinehart's testimony:

> "Q. Now, with respect to Dow Methocel 65-HG, is that product an alkyl hydroxy alkyl cellulose mixed ether in which the alkyl group contains 1 to 4 carbon atoms and the hydroxy alkyl group contains 2 to 4 carbon atoms? Shall I repeat the question? A. I believe I have it, yes.
>
> Q. Your answer to the question is yes? A. *Yes.*" [Ex. AE, pp. 7-8; Emphasis added].

The identity is even more conclusively established by the testimony of Mr. Greminger, an authority on cellulose ethers employed by the Dow Chemical Company, testifying in deposition as follows:

> "Q. Mr. Greminger, you have indicated a presentation for hydroxypropyl methylcellulose on Exhibit AH. Is that material a simple or a mixed ether? A. This would be considered a mixed ether.* * *

Q. Referring to Exhibit AH, will you tell us how many carbon atoms are in the alkyl group? A. There is one.

Q. Referring to the same exhibit will you tell us how many carbon atoms are in the hydroxyalkyl group? A. There are three." [Ex. AD, pp. 22-23].

The direct quotations from deposition testimony and Exhibit P conclusively establish that the accused mortars were patented to Kaveler *long* prior to the applications for the patents in suit. Therefore the defendant has not infringed the suit patents, but on the contrary *has operated under a considerably-earlier* patent.

B. The Accused Products Could Not Have Been Copied From the Patentee and the Finding to That Effect Is Unsupported.

On the basis of finding that Tilers Supply copied the accused products from the Council, the District Court awarded costs in this action, and referred the case to a Master for a determination of whether or not damages shall be increased. The Finding not only is unsupported by the evidence but additionally the fact found could not have occurred! Tilers Supply *could not have copied a recipe that the Council did not know.*

The District Court below made a specific finding [R. 141, No. 33] to the effect that Defendant copied the accused products from Plaintiff. The compositions which Tilers Supply has been found to have copied would of necessity be a mixture of *sand or limestone, methylcellulose and Portland cement* in certain propor-

tions, because that is what the patents cover. However, Tilers Supply could not have copied the mixture because:

1. The Council *did not appreciate the necessity of sand* in the composition until long after Tilers Supply was making and selling the accused mortar mixes;
2. The Council preserved all formulas and related information *in complete secrecy* until patents thereon issued, and Tilers Supply sold the accused mortars long before the earliest of patents in suit issued.

To consider the pertinent events chronologically, Tilers Supply published (under the authorship of its principal officer, Mr. Knesel) a series of articles on mortars which Tilers Supply were introducing to the market. Those articles were published in "The Tile Magazine" [Ex. 11] beginning in January, 1958. The only evidence offered by the Council to support the allegation of plagiarism is testimony by the patentee of the patents in suit to the effect that the published articles described accomplishments similar to what the Title Council and he were working on. Specifically, the testimony is as follows:

"Q. I refer you, Dr. Wagner, to two short passages in Exhibit 11, the first stating, 'During this latter period research was going on to find a cement based product that would possess all of the properties desired for a thin-set cement mortar.' And, at the very last of the indicated part, toward the end of the article, 'Through valiant research it appears that most of these questions have been answered.'

Now, in this article was Mr. Knesel speaking about the TCA development of dry-set mortars?

MR. NILSSON: Objection. Outside the scope of the witness' knowledge.

MR. PINE: Well, I am going to ask him next, after he answers, what the basis for his answer is. And it will be based on facts to the extent that he knows.

THE COURT: Does he have some personal knowledge?

I think that the question could be rephrased, 'Based upon your scientific opinion, is this the type of work that is referred to in this article that you were doing,' something like that.

MR. PINE: Thank you very much, your Honor.

Q. Dr. Wagner, was this the type of work that you were doing in this field? A. Yes, it was exactly that type.

Q. And do you know, Dr. Wagner, of anyone else in the United States who did make developments in this field who utilized a scientific approach such as is described here? A. No. I know of no such person." [Tr. 167-168].

The conclusion of plagiarism from this testimony is ludicrous! The testimony is not probative of copying, but merely states that the witness recognized a *description of work similar to his* and states that he was not aware of any similar work in the United States, which utilized what he terms a "scientific approach."

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Although the Council had at that time (January, 1958) filed the application for the patent 2,934,932 neither the Council nor the individual applicant then recognized that sand or limestone was a necessary ingredient of the mortor recipies as eventually patented. This lack of appreciation is clearly borne out in Exhibit AB, the prosecution file history of the patent, specifically on page 22 where the subject matter of the patent application is said to reside primarily in a "dry-mix mortar composition without sand or limestone."

As a matter of public record, this assertion was made to the Patent Office early in June, 1958. Some six months after Tilers Supply had published articles describing developments manifest in its new products, the Council still did not know that sand or limestone was a requisite ingredient to the development. If the Council did not yet appreciate the ingredients of their "development" and further had not disclosed such, it is inconceivable that Tilers' Supply could have copied such developments from Council.

Further conclusive of the absence of any copying on the part of Tilers Supply from the Council is indicated by the testimony of Mr. Goodrich representing a member of the Tile Council and being personally active in the Council and a previous member of the Council's research committee at the time referred to, who testified that the Council's information was preserved in secrecy, as follows:

> "We never allowed anyone to disclose this information by our staff to even the members of the research committee. The only information that we got on this was when our patents were issued and they became public knowledge." [Tr. 39].

The first of the suit patents therefore was preserved in secrecy until May 3, 1960. At that time, Tilers Supply had been making and selling the accused products as described in the published articles for over two years.

C. The Award of Costs and Consideration of Increased Damages Is Unsupported.

The Court concluded that the accused products represented a deliberate and wilful infringement of the asserted patents [R. 162, Concl. 41] and instructed that a Master may recommend increased damages. The conclusion is based on a finding of deliberate copying by Tilers Supply. No substantial evidence exists to support the Court's judgment and both the finding and the conclusion are in error.

The finding of copying has been considered in the previous section which is submitted to establish two aspects. First, Tilers Supply products simply could not have been copied from the Council because the Council did not realize the necessity of *sand* or *limestone* in such formulations until long after Tilers Supply introduced the products on the market. Second, the evidence offered to support a finding of copying is sorely lacking. The evidence on this point is not in conflict, however, it establishes only that the parties were both active in the same technical area. A conclusion that one of the parties copies from the other certainly is not supported by such evidence. Indeed, if any inference is to be drawn, it would logically be that the Council copied from Tilers Supply who was first to publish and first to produce for the market.

As Tilers Supply did not copy (willful or otherwise) their formulations from the Council, no basis for a

recommendation to consider increased damages can be found. In this regard, recent case effectively summarizes the law on this point as follows:

> "Assuming that before the Court can increase the amount of actual damages for infringement under Title 35, United States Code, Section 284, it must find wilfulness,[1] McCulloch asserts that the word 'wilfulness' has had a definite meaning attached to it by the decided cases.
>
> The courts have struggled with the word 'wilful' not only in patent cases but in criminal cases as well. See the leading case on the subject of Murdock v. United States, 390 U.S. 389, 393-396 (1933).
>
> The many cases touching on awards of additional damages under 35 U.S.C. 284, range in their expressions as to what will support such an award, from faithful copying, and lack of 'good faith' [Coleman v. Holly, 9 Cir. 1959; 269 F.2d 660, 122 USPQ 559], to fraud [Armstrong v. Emerson, S.D. N.Y. 1959, 179 F.Supp. 95, 123 USPQ 133], oppressive conduct [Laskowitz v. Marie, S.D. Cal 1954; 119 F.Supp. 541, 100 USPQ 369], and where validity and infringement are not open to 'honest doubt' [International Mfg. v. Landon, Inc. (9 Cir. 1964), 336 F.2d 723, 142 USPQ 421, cert. den. 379 U.S. 988, 144 USPQ 780.]." *McCulloch Motors Corp. v. Oregon Saw Chain Corp.* (S.D. Cal. 1965), 245 Fed. Supp. 851, 856, 147 U.S.P.Q. 175, 186.

It is submitted that no evidence exists to establish any of the criteria recited. Tilers Supply did not copy, faithfully or otherwise. In this regard, it is note-

worthy that Tilers Supply products contain several ingredients foreign to the patented recipes. Tilers Supply was in no manner fraudulent. The questions of *validity* and *infringement* were (and remain) in very serious doubt. Therefore, it is respectfully submitted that the conclusion to consider increased damages is unsupported and erroneous.

Conclusion.

For the reasons stated, it is respectfully submitted that the District Court's injunction and damage award, based on adjudging the asserted patents valid and infringed, be reversed, and the cause remanded with instructions that the patents are invalid and not infringed.

Respectfully submitted,

NILSSON, ROBBINS & ANDERSON,
By B. G. NILSSON,
Attorneys for Defendant.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

Byard G. Nilsson.

APPENDIX.

Table of Exhibits.

Exhibit	Identified	Offered	Received
B	475	475	475
G	475	475	475
J	475	475	475
P	475	475	475
AB	485	485	485
AD	903	904	904
AE	903	904	904
AH	Deposition Exhibit of Exhibit AD		
BJ	786	823	823
ZZ	484	485	485
11	162	164	164
15	96	97	97

IN THE

United States Court of Appeals

For the Ninth Circuit

No. 21160

CERAMIC TILERS SUPPLY, INC., a corporation,
Appellant,

against

TILE COUNCIL OF AMERICA, INC., a corporation,
Appellee.

APPELLEE'S BRIEF

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

PAGE

Cases:

ther Authorities:

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No. 21160

Ceramic Tilers Supply, Inc., a corporation,
Appellant,
against

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APPELLEE'S BRIEF

Statement of the Case

Plaintiff recovered judgment (R 164-167) that claims numbered 1, 2, 4, 5, 6, 7, 8 and 9 of its '932 patent and claims 1, 2, 4, 5, 6, 7, 8, 9 and 10 of its '382 patent, each relating to a composition or technique for setting ceramic tile, are valid and infringed (R 164, 165) on a written Opinion of the District Court, Francis C. Whelan, District Judge (R 126-132), separately supported by Findings of Fact and Conclusions of Law (R 133-163).

Two patents are under consideration. U. S. Patent 3,934,932 issued May 3, 1960 upon an application filed Sep-

tember 30, 1957 by Dr. Herman B. Wagner. The second patent, U. S. 2,990,382, issued June 27, 1961, upon an application filed October 9, 1957 by Drs. Herman B. Wagner and John V. Fitzgerald. Both patents are directed to hydraulic cement containing mortars for dry-setting ceramic tile without the need for wetting down the substrate or the tile with water.

The Issues Presented

This is not, as defendant would like to have it, a contest over mortar "mixes" and "recipes", workman's variations in products long used and known. The subject matter is not of that caliber at all. Rather, the patents in suit are shown by the unrebutted proof to have provided, in a very old industry, entirely new products and methods which achieved new and unexpected results, which met and completely overcame problems long encountered, which went immediately and extensively into use, which displaced existing techniques, and which have been unanimously acclaimed by friend and foe alike in this litigation. The main issue on this appeal is whether, unlikely as it may seem, these products and methods were already available to the industry so that it is fair to invalidate the patents as having contributed nothing.

This issue is not to be decided by a mere tabular comparison of ingredients mentioned by coincidence in old and unrelated patents. The inquiry must be as to whether the prior art does in fact make the teaching which the industry adopted and found so valuable, for if the art does not do so, then it is fair to reward those who did make the contribution and it is the object of the patent law to do so.

"No doctrine of the patent law is better established then that a prior patent or other publication to be an anticipation must bear within its four corners adequate directions for the practice of the patent invalidated. If the earlier disclosure offers no more than a starting point for further experiments, if its teaching will sometimes succeed and sometimes fail, if it does not inform the art without more how to practice the new invention, it has not correspondingly enriched the store of common knowledge, and it is not an anticipation."

> *Dewey & Almy Chemical Co.* v. *Mimex Co.*, 124 F.2d 986, 989 (2d Cir. 1942).

Defendant, understandably, seeks to avoid the record on commercial success on the ground that the prior art anticipates. It will appear, however, that the art is very far from teaching the inventions of the patents here, that the inventions do have novelty, and their ready acceptance by the industry is very pertinent, as has recently been held by the Supreme Court:

"Under §103, the scope and content of the prior art are to be determined; differences between the prior art and the claims at issue are to be ascertained; and the level of ordinary skill in the pertinent art resolved. Against this background, the obviousness or nonobviousness of the subject matter is determined. Such secondary considerations as commercial success, long felt but unsolved needs, failure of others, etc., might be utilized to give light to the circumstances surrounding the origin of the subject matter sought to be patented. As indicia of obviousness or nonobviousness, these inquiries may have relevancy."

> *Graham* v. *John Deere Co.*, 383 U. S. 1, 17-18 (1966).

There is no issue raised by an alleged inattention of the court below to the prior art, as defendant contends. The plaintiff presented extensive expert testimony on the characteristics and features of the patented inventions and their comparison with the prior art. The defendant presented next to none. The defendant relied on some twenty-five (25) items of prior art, no one of which did it feel it could proceed without (1305-6, 1314).* This in itself is indicative of the weakness of the art to invalidate. *Reynolds* v. *Whitin Mach. Works,* 167 F.2d 78, 83 (4th Cir. 1948). The court below found that the prior art did not teach the inventions (R 14, 15; Findings 42, 43), and concluded that the patents were valid thereover (R 26, 27, 28; Conclusions 21, 22, 23, 24, 25, 26, 27, 28).

Referring further to defendant's efforts to embellish the prior art in ways that do *not* raise issues on this appeal, defendant says in its brief that at various times during prosecution of the patents "* * * the Heijmer patent was in the background" (Brief, p. 27), and "the Patent Office lost sight of the 'primary reference'," Spillman (Brief, p. 29). Defendant must, of course, do what it can to discount the fact that the best references it can adduce were considered and rejected by the Patent Office, but it clearly cannot do so by assertions about the subjective state of the patent examiner which are supported by not a shred of evidence, and which are contrary to the plain record of the file history. The fact is that the art does not teach the inventions, and the Patent Office and court below both properly so decided.

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* Number references are to the Transcript, unless otherwise noted. "R" references are to the Record on Appeal.

Another false issue is the statement at page 7 of defendant's brief that the opinion of the court below was "totally silent" on the allegation of fraud on the Patent Office. The reason, of course, is that defendant made no reference whatever during the trial or in the full day of final argument to an alleged fraud which it now raises. Defendant did mention in the Pre-Trial Order some unspecified alleged transgression in the Patent Office (R 96). Nothing of this sort was ever argued, and the court below accordingly found as a fact that there was no irregularity in the prosecution of the patents (R 148, Finding 49). The issue now raised in the brief so little appealed to defendant that it did not even include it in its Statement of Points (R 188), but only added it to this appeal as an afterthought (R 194).

Summary of Argument

The inventions fully met needs long existent in the ceramic tile setting industry. They met with instant success and have been universally acclaimed by the industry.

The inventions are not taught or even suggested in any of the prior art. The British Spillman patent, on which defendant for the first time on this appeal places its main reliance for anticipation, should not even be considered against the '932 patent, defendant never having given the written notice thereof required by *35 U.S.C. §282.*

Even though Spillman were to be considered, it is ineffectual to invalidate. Spillman is concerned with a paint or plaster, a material entirely different from the tile holding

adhesives of the invention. The products are different, the problems are different, and Spillman fails to make the critical inventive teaching of Wagner for the very good reason that he was not aimed in the same direction at all. Spillman does not teach how to provide a very high viscosity in the water phase of a Portland cement adhesive for setting tile, and, not having done so, his miss is a mile from the Wagner invention. Spillman also, not directed to the Wagner product, contains different ingredients, such as a large percentage of chalk. This too renders Spillman ineffective to meet Wagner.

Spillman fails to meet the '382 patent mortar for the same reasons, and for the additional reason that it does not teach the use of the dry, redispersible polyvinyl acetate component, which in the Wagner product results in a synergistic effect with the methyl cellulose. Defendant's own expert testified to the difference between the dry, re-emulsifiable polyvinyl acetate of Wagner and the emulsion of Spillman.

Spillman fails to meet the standards for a reference the law requires of it as a foreign patent, and it is further ineffective because it teaches no more than the Heijmer patent, which was considered and rejected by the Patent Office.

The answer to defendant's argument of non-infringement is that the methyl hydroxypropyl cellulose used in its products is in fact the methyl cellulose described in the patents, but, in any event, the two are complete functional and legal equivalents of each other. Defendant's plea that

it is following the Kaveler prior art patent is disproved by the fact that defendant is not producing the Kaveler slurries for cementing oil wells, but is producing dry set, thin set mortars as taught by Wagner.

The cry of fraud falls because defendant's tortuous argument fails to include any misrepresentation whatever to the Patent Office.

Finally, the trial court was fully justified in permitting the Master to consider multiple damages because it was properly found that defendant deliberately copied its products from the plaintiff, and the false and deceitful testimony adduced at trial by defendant was inequitable conduct of the gravest sort.

Background of the Patents

The patents in suit are the product of the Research Center which the Tile Council of America maintains near Princeton, New Jersey (18). The Tile Council is a trade association with a membership of the ceramic tile manufacturers of the United States (11). The function of the Research Center is primarily to develop ways to reduce the installed cost of ceramic tile and to prepare product and installation specifications, all, of course, in order to promote the use of ceramic tile (18).

The research which led to the developments covered by the patents was undertaken in 1955 to meet the problems which were recognized in the use of then-existing materials to set ceramic tile (19). The success of the research was

quite dramatic. Entirely new ceramic tile-setting materials evolved which came to be known as "dry-set" mortars, and they were used in a new setting technique called the "thin-setting" of ceramic tile (18, 52, 53, 63-69, 93, 94).

Through its licensing committee, the new tile-setting materials were widely licensed to the industry by the Tile Council immediately after their development (21), they began to be manufactured in 1957 (382), and since that time they have achieved wide usage in industry, displacing earlier materials and methods and becoming the most prominent techniques for setting ceramic tile (161, 382, 383, 1397, 1434-35).

Ceramic Tile Setting Prior to the Inventions

The conventional ceramic tile-setting techniques in use in 1955 were the so-called "mud" method, and the use of organic adhesives, or mastics (19, 20, 73, 74, 79-83).

The "mud" installation involved the use of cementitious materials in several layers aggregating about an inch in thickness, which was heavy, slow and expensive to install. The first step was to water-soak the masonry backing, or substrate, then apply a scratch coat about one-fourth (¼) inch thick made up of Portland cement, sand and lime. This was allowed to harden. The setting bed was next troweled on, allowed to harden, and then the "dope" coat was put on. This latter was a thin layer of "neat" or pure Portland cement, in which the ceramic tile is finally set. If the tile to be set were relatively water-absorbent, called the non-vitreous type of tile, the tiles themselves had to be thor-

oughly water-soaked prior to setting in the cement. The necessity for water-soaking the masonry backing before applying the scratch coat, and for soaking absorptive tile before setting it in the mortar, is that otherwise water in the mortar mixture will be quickly sucked out and lost to the pores of the dry substrate or dry tile. In order for cement properly to set or cure and provide the strong bond desired, water must be available for chemical reaction with the cement. If this water is all or largely absorbed by the adjoining substrate or tile, the mortar does not cure, and a proper bond is not formed. The tile falls off. The mud method because of its weight could not be used at all to install tile on certain backings as, for instance, on a plywood wall (19, 35, 36, 38, 72, 73, 79-85).

A technique for setting ceramic tile newer than the mud method, coming into use some twenty (20) years ago, was that in which the tile was adhered to the substrate with an organic adhesive. These adhesives were made of rubber or rubber-type material which was milled with organic solvents and fillers, kneaded and masticated so that the rubber compound was swollen or semi-dissolved in the solvent. These adhesives were sometimes called "mastics" because of the masticating operation in their manufacture (1398).

The mastics provided a thinner and lighter setting bed than the mud bed, and did away with the need for water-soaking of tile and substrate. However, they brought some very serious problems of their own. The organic solvents used in them were both toxic and flammable, making their use hazardous to workman and property. They were hard to clean off from tile and other surfaces after an installation

was made, requiring the use of further toxic and flammable organic solvent to do the cleaning. They had only fair resistance to water, which limited their use in showers and other damp environments. They could not be used as a leveling medium. In laying tile, it is frequently desired to level-up a rough or low spot in the substrate with the adhesive, by applying a thicker coating in such places. With organic adhesive this could not be done, because the thicker bed of adhesive would not permit the solvent to evaporate, and the setting bed would never harden (19, 73-76, 79-83, 1395).

Other systems for setting tile were in use to a very minor extent at the time of the development of the Tile Council dry-set and thin-set mortars. These, like the mastics, were aimed at the problem of water loss from conventional cement to dry adjoining elements, which required soaking of substrate and tile in the mud technique. In one such system, liquid latex emulsion or similar additives were made to cement when preparing it for use, in order to inhibit loss of water. The trouble with these materials was that two entirely separate items, the dry adhesive and the liquid additive, must be manufactured, handled, stored, and mixed together by the workman at the site of the work (20, 382, R 137).

In another system, a sealing coat of liquid was applied to the substrate to prevent water loss from the mortar setting bed into it. This merely replaced a soaking step with a coating step requiring an additional material, in an already long, complicated and expensive process (20, 382, 1396).

The Patents in Suit

The inventor of the '932 patent in suit (2,934,932) is Dr. Herman B. Wagner, presently Professor of Chemistry at Drexel Institute in Philadelphia. He has his Bachelor's degree in Chemical Engineering, and his Master's and Doctor's degrees in Chemistry from Johns Hopkins University in Baltimore (51). He was employed by the Tile Council in 1955 to head the chemical research at the Research Center (52).

The '382 patent in suit (2,990,382) is the joint invention of Dr. Wagner and Dr. John Vincent Fitzgerald, the latter being the Research Director for the Tile Council since 1952. He is a PhD. in Physical Chemistry from M.I.T. (Ex. ZZ, p. 38).*

The '932 Patent

The key concept of the invention was realized when Dr. Wagner attacked the problem of water loss from cementitious tile-setting compositions. In the words of Dr. Wagner:

> "* * * it occurred to me that with a dry absorbent tile, for example, the main cause of the soft joint or grout was the fact that when the older compositions containing cement and water first contacted the tile, the water would rapidly move into the dry tile and it would only be available for hardening for a very short and insufficient period.
>
> "So the next step in my thinking process was, how can we prevent this flow of water into the absorbent

* Ex. references are to trial exhibits, unless otherwise noted.

> tile? Well, a number of thoughts occurred, but the one that finally looked most promising to me was to increase the viscosity or consistency of the water that initially was put in with the cement to such an extent that this very thick viscous fluid now would not rapidly flow into the pores of the dry tile. It would remain behind, stay with the cement, and provide the proper hardening." (60)

In order to accomplish his purpose, Dr. Wagner chose to use a water-soluble cellulose ether which could produce a tremendous increase in the viscosity of water:

> "Now, in order to increase the viscosity of water we need something which is not only a large molecular weight or polymeric substance, but we need a polymer that is also soluble in water. It must dissolve in water. Most polymers are not soluble in water.
>
> "If I take a polymer that is not soluble in water and put it in water, I do not effectively increase the viscosity of the water. It is only when I take a high molecular weight or polymer molecule that is capable also of dissolving in water that I have a tremendous increase in viscosity which would serve the purpose I was looking for here." (62)

It is this concept which was principally responsible for the success of the invention, and it is this concept which is completely lacking in the prior art, as we shall show later.

The patent quite fully discloses this feature of the invention.

> "This water-retentive property is obtained by causing the viscosity of the liquid phase obtained upon

> water addition to the compositions to be sufficiently high so that no egress of the water to tile or substrate will occur or so that the rate of such water loss is greatly diminished. This effect of increased viscosity may be accomplished by adding to water any sufficiently water-soluble polymeric substance." (Ex. 1, 2/50-58)*

A material disclosed to impart the important property of water-retention to the mortar was dry methyl cellulose powder of sufficient solubility to greatly raise the viscosity of the mortar water phase in use:

> "I have found that given viscosity types of methyl cellulose, used in appropriate proportions to Portland cement and water, yield compositions that have the required water phase viscosity characteristics, do not flocculate the Portland cement, are not precipitated by constituents of the portland cement, and do not prevent hardening of the Portland cement. I have found that, in order to obtain the degree of water-retentivity required for this purpose, a minimum water-phase viscosity in the mortars of about 500 centipoises must be obtained and I have developed compositions of methyl cellulose, Portland cement, water, and other ingredients which meet these requirements and I have used, along with certain application techniques, to set ceramic tile." (Ex. 1, 2/68-3/9)

Dr. Wagner's concept of the use of dry but highly soluble methyl cellulose capable of greatly raising the viscosity of the water phase permitted the preparation of an all-dry mortar which could be sacked and sold, and needed only water to be added for use when tile was to

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* 2/50-58 refers to column 2, lines 50 to 58 of the '932 patent, Exhibit 1.

be set. This obviated the inconvenience and possibility of error inherent in the handling and measuring of several wet and dry materials at the job site. The highly viscous phase of the prepared mortar did not readily lose water to a dry substrate or to dry non-vitreous tile set in it. The need to soak substrate and tile with this mortar composition was thus entirely eliminated.

Still another feature of the invention covered by the '932 patent was the necessary inclusion of a grained substance such as sand or limestone in the composition:

> "A particular feature of the invention is the development of improved compositions including ingredients as sand, limestone and the like and also the determination of the proper variations in composition that should be made in practical use to provide for workable mortars where only a relatively short slaking time can be allowed or where mixing and dispersion is of a degree common or practicable in actual field use." (Ex. 1, 3/10-17)

A surprising and unlooked-for result in the use of sand or grained aggregate in the mortar composition was that the tile could be set directly on the substrate with the mortar, without the use of the neat or pure coat of cement between the tile and the setting mortar. This neat coat always had been used in the setting of tile with cementitious adhesives, but it proved to be entirely unnecessary with the new mortar (82, 83, 237, 579, 1402). The use of sand in the composition was found to be essential to the best use of the new adhesive in the setting of vitreous ceramic tile (1402).

The new mortar was utilized in a new and simplified technique for setting tile. The all-dry mortar composition was mixed with water and then applied directly to a dry substrate in a setting bed of only about ⅛ to ¼ of an inch thickness, after which dry, unsoaked tile, whether vitreous or non-vitreous, was set in the bed, and the operation was complete.

Trial Exhibit 30-6 which is reproduced on the fold-out page, illustrates the vast simplification achieved with the new dry-set and thin-set mortar. Three (3) separate coatings of material and two (2) soaking operations were necessary in the mud method, with long waiting time, and heavy, thick and expensive material usage. With dry-set the mortar is directly troweled on the dry substrate, the dry tile is set, and that is the end of it (65-68).

Exhibit 30-4 illustrates another surprising result of the new mortar. Despite the great savings in materials and time for installation, the new mortar actually created a far stronger bond of the tile on the substrate (70, 71).

Exhibit 30-5 illustrates the savings in weight and materials realized, with the weight of mortar in the new technique amounting to only one-twelfth (1/12) of the conventional mud set method and lying in a bed only one-twelfth (1/12) as thick (72).

The new mortar also provided numerous advantages over organic adhesives, as shown in Exhibit 30-7. The new cementitious mortar was found to have far greater bond strength, its water resistance when set was excellent, yet

the job could be cleaned up with water, it was non-inflammable, it could be used for exterior tiling, and it could be used to level rough or low spots in the substrate (74-78),

All of these desirable and unforeseen characteristics of the patented mortar are unrebutted on the record, they were properly found as fact by the court below (R 137-139), and they are legally indicative of patentable invention.

> *Phillips Petroleum Co. v. Ladd,* 219 F.Supp. 366, 369 (D. D. C., 1963).

The '382 Patent

The '382 patent covers an improved mortar of the kind disclosed in the '932 patent. In the words of Dr. Wagner:

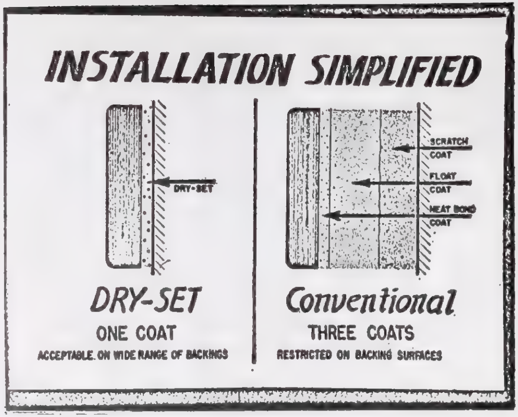
> "* * * the '382 mortar embraces all of the advantages of the earlier discussed mortar, plus the additional advantages of flexibility and further optimized bonding properties." (94)

The mortar could be used for setting ceramic tile on plywood, whereas this ordinarily is considered to be too flexible to serve as a good backing (220).

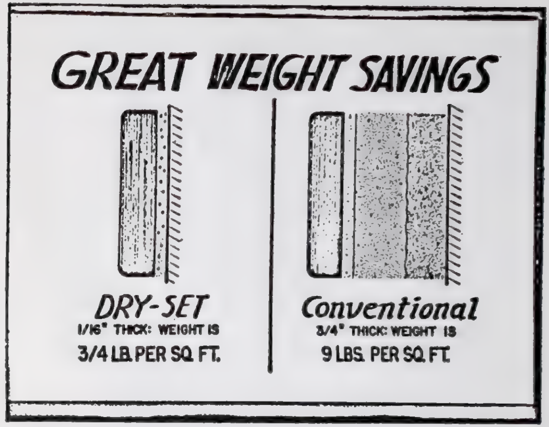
The patent describes the invention as follows:

> "It has been found that the foregoing objects may be realized by mixing in a dry state a hydraulic cement such, for example, as Portland cement, methyl cellulose of medium to high viscosity, and a water insoluble, reemulsifiable polyvinyl acetate. The resulting mix may then be combined with water to form a settable composition which forms a cement having

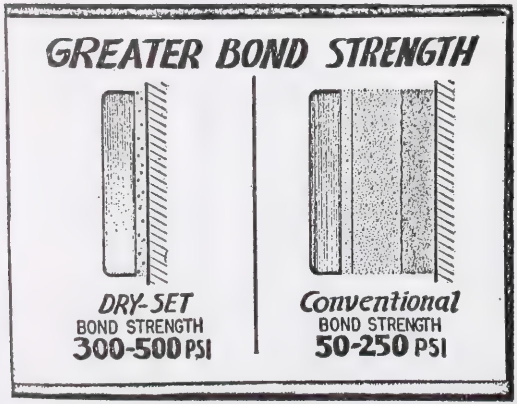
Ex. 30-6



Ex. 30-5



Ex. 30-4



Ex. 30-7

DRY-SET VS. ORGANIC ADHESIVES

	DRY-SET	ADHESIVE
CAN BE LEVELED	YES	NO
BOND STRENGTH	300–500 PSI	25-200 PSI
WATER RESISTANCE	EXCELLENT	FAIR
WATER CLEANABLE	YES	NO
NON-FLAMMABLE	YES	NO
IMPACT RESISTANCE	EXCELLENT	FAIR
EXTERIORS	YES	NO

> unique dry curing properties and flexibility." (Ex. 2, 2/37-43)
>
> "In carrying out the principles of this invention in the manner indicated above, a single, all-powder cement-methyl cellulose-polyvinyl acetate mix is provided which can be delivered as such to the use-site, whereupon it can be practically and advantageously mixed with a specified amount of water to give a plastic, pliable composition having wide application of use" (Ex. 2, 3/17-24).

A surprising and unlooked-for result in this mortar was the fact that a synergistic effect took place between the methyl cellulose and the polyvinyl acetate with respect to the dry-setting properties of the composition. Such an effect is one in which the actual results realized from the combination of two (2) materials far exceed their individually added properties (229, 232). The effect is stated in the patent as follows:

> "The overall dry curing properties, bonding properties and flexibility of the mortar compositions of this invention containing both methyl cellulose and polyvinyl acetate are far superior to cement compositions containing only methyl cellulose or polyvinyl acetate. Both methyl cellulose and polyvinyl acetate contribute to the dry curing properties of the resin." (Ex. 2, 4/55-62)

The court below found on the unrebutted evidence the new characteristics and advantages of the '382 mortar (R 139). It also found the surprising and unlooked-for result of the synergistic effect (R 140), and this too is indicative of invention. *University of Illinois Foundation v. Block Drug Co.*, 241 F.2d 6, 12 (7th Cir. 1957).

ARGUMENT

I. THE PATENTS ARE VALID.

A. Spillman is Not Available Against '932.

Defendant, never having asserted Spillman (Ex. J) against '932 below, is prohibited from doing so at this late date by the provisions of 35 U.S.C. §282.* Under that statute, defendant was required to give written notice to plaintiff "at least 30 days before trial" of any patents or publications intended to be relied upon as an "anticipation" or as "showing the state of the art" of the '932 patent.

The only written notice fitting the description of §282 ever received by plaintiff was defendant's "Memorandum of Contentions of Law and Fact"**, served June 11, 1963. In that written notice, however, Spillman British Patent 743,952 (Ex. J) was *not* asserted against '932, or ever pleaded as being in any way pertinent or relevant to the invention of that patent.† Nor did defendant ever ask the trier of fact for leave to adduce that reference as evidence of invalidity of the '932 invention.

Under §282, defendant cannot urge Spillman against '932 for the first time on appeal. *Blanchard* v. *Putnam,*

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* Appendix, 3a-4a.

** The relevant pages, 15 to 18, of this Pleading are reproduced in Appendix, 8a-12a.

† Defendant's failure to plead Spillman against '932 was no oversight. In this same memorandum, page 18, British 743,952, which is Spillman (Ex. J), was cited against '382 as "illustrative of the prior art". Appendix, 12a.

75 U.S. 420, 427 (1869); *Thermo King Corp.* v. *White's Trucking Service, Inc.,* 292 F.2d 668 (1961). The traditional rule against raising points on appeal which were never heard below also bars defendant from asserting this completely new issue before this Court. *Hormel* v. *Helvering,* 312 U.S. 552 (1941); *Hebets* v. *Scott,* 152 F.2d 739 (9th Cir. 1945).

B. Spillman Does Not Invalidate.

Spillman is directed to a paint or plaster intended to be applied to a wall in a fluid condition and to dry upon exposure to air to form a decorative surface coating whose primary function is to be aesthetically pleasing.

In contrast, the dry-set Portland cement mortars of the patents in suit have a structural—not an aesthetic function. They must tenaciously bond together in the dry state two essentially different types of building materials, i.e., ceramic tile pieces, including highly absorptive non-vitreous and non-absorptive vitreous tile, and any one of a wide variety of highly absorptive building foundation substrata, such as concrete, plaster, gypsum wallboard, wood, and the like.

Prior to the patents in suit, there was no known hydraulic cement mortar which would perform this function, and hence the tile art had to resort to wetting down the building foundation and tile with the many consequent disadvantages of such a technique, discussed *supra.*

The test of anticipation here is whether a man grappling with the problems solved by the patents in suit

and having no knowledge of the patents, but having the Spillman patent in his hand, would have said: *"That gives me what I wish."**

Spillman fails this test.

Spillman is not concerned with the loss of water from a tile mortar to an absorbent substratum or the tile itself. He does not teach the Wagner concept of utilizing a water-soluble polymeric material to increase the viscosity of the water phase of such a mortar to thereby prevent egress of the water out of the mortar into the surrounding environment. He does not disclose a unitary dry composition readily activatable at the job site by the mere addition of water to produce a mortar having such a water-retentivity characteristic, and which is further capable of forming a strong bond between all available ceramic tile and building substrata.

Spillman, in other words, contains no recognition of the problems faced by the tile setting art on the eve of the inventions and affords no solution to those problems. It is not enough for defendant to contend that Spillman can be made to produce one result or another. For anticipation, Spillman's specification must give in substance the same knowledge and same directions as the patents in suit. "Inferences as distinguished from disclosures, especially when drawn in the light of after events, cannot be asserted as a basis of anticipation."**

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* *Skelly Oil Co.* v. *Universal Oil Products, Co.,* 31 F.2d 427, 431 (3rd Cir. 1929).

***Id.*

1. Spillman does not teach the use of methyl cellulose to increase viscosity.

When water is added to the unitary, dry compositions of the patents, the methyl cellulose dissolves and increases the viscosity of the water tremendously, thereby imparting to the mortar the crucial property of water-retentivity.

Methyl cellulose which is not capable of increasing the viscosity of water would result in a bond failure between tile and building foundation, a truly catastrophic event should it occur in a modern building of any size.

Dr. Wagner achieved the property of water-retentivity in his mortars by the use of given types of methyl cellulose which are not only soluble in water but, more importantly, are capable of raising the viscosity of water tremendously.

This feature of the methyl cellulose component of the mortar of the patents is brought out, for example, in the '932 patent claims, wherein it is stated that the methyl cellulose is of 10 to 7,000 centipoise viscosity grade. Dr. Lacey* explained that the viscosity of pure water is 1 centipoise (1343). From the testimony of Dr. Wagner (103-105), this claim limitation means that the methyl cel-

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* Plaintiff's expert, Dr. Lacey, received the Degree of Doctor of Philosophy from the University of California at Berkley in 1913, had a long and varied teaching career at the California Institute of Technology, where he served as Professor of Chemical Engineering, Dean of Graduate Study, and Dean of Faculty, and is currently professor emeritus in chemical engineering. He has served as a member and Vice President of the California State Board of Registration for Civil and Professional Engineers, and has received many awards for outstanding academic and professional achievements (239-240).

lulose, when dissolved in water to a concentration of 2%, must have the capability of increasing the viscosity of the water at least 10 times! A more stringent viscosity increasing capability for methyl cellulose is required by the claims of the '382 patent.

Methyl cellulose having the viscosity rating called for by the patents must possess two essential characteristics: (1) it must have a degree of substitution between 1 and 2 so as to provide good water solubility*; and (2) it must have a cellulose molecule chain,** long enough to increase the viscosity of water the stated amount upon dissolution therein.

The viscosity rating (e.g., 10 centipoise methyl cellulose) as used in the patents, in other words, is a shorthand expression which describes these two highly complex scientific characteristics of a particular type of methyl cellulose which can be used to practice the patented inventions.

Neither the term "viscosity" nor the concept of water-retentivity is found in Spillman. Nor does Spillman describe either the degree of substitution or the chain length of his "methyl cellulose".

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* "Cellulose itself is essentially water insoluble. But as you put more and more of the methoxy groups in you develop more and more water solubility, and you get fairly good water solubility between one and two substitutions out of a possible three" (Lacey, 303).

** "I might say that the length of the molecule in the methyl cellulose depends largely on the length of the molecule of cellulose on which it is built, and the viscosity of the methyl cellulose depends very largely on the length of these chains, whether they are short chains or very long chains, and the treatment of the original cellulose in purification has a great deal to do with the resultant length of these chains, whether they are broken down into smaller ones or kept as quite long chains" (Lacey, 302).

The problem with Spillman as an anticipation therefore is not what he actually discloses, *but rather what he fails to disclose. Dewey & Almy Chemical Co.* v. *Mimex Co.*, 124 F.2d 986, 990 (2nd Cir. 1942). Protestations of counsel are not sufficient to cure these disclosure failures, which are fatal.

The mere fact that Spillman mentions an "aqueous solution of methyl cellulose" is no help to defendant.

The term "solubility" as applied to cellulose ethers is a complex phenomenon which has many different shades of meanings as testified to by defendant's expert, Dr. Stone.* Dr. Wagner, recognizing this fact, did not leave this critical property open to argument or interpretation when he prepared his patent applications. To the contrary, he specified the viscosity rating for the methyl cellulose, and thereby definitely defined the degree of solubility necessary to produce the required degree of water-retentivity in his mortars.

The complete failure of Spillman to take even the most elementary precaution to state a viscosity rating for his methyl cellulose or to describe a degree of substitution

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* "Well, solubility is not a simple phenomenon, particularly when one is dealing with colloid chemistry. It becomes a rather moot point and subject to some discussion among chemists what constitutes solubility and what does not constitute solubility—particularly with materials of this type.

"For example, if you take methyl cellulose, simple methyl cellulose with a degree of substitution of approximately 1, you can dissolve it in water at room temperature. But as you start to raise the temperature the material gels the solution. Now, at that point a colloid chemical phenomenon is taking place, a physical change is taking place; and chemists would argue, well, is the material still soluble or is it not at that point." (Stone, 795)

or a chain length for his material, or to define in any other way what he intended by the phrase "aqueous solution of methyl cellulose" speaks louder than words. Since Spillman was not aiming at the target of the patents, he did not require methyl cellulose which is capable of increasing water viscosity. To Spillman, in other words, methyl cellulose viscosity was a matter of complete indifference.

Heijmer (Ex. F) and Kaveler (Ex. P) were the two primary references asserted by defendant at trial, but dropped on appeal. Understandably so, since both refute defendant's contention that when Spillman says "aqueous solution of methyl cellulose" he intends a methyl cellulose having the chain length and degree of substitution required to provide the viscosity taught by the patents in suit.

Heijmer, like Spillman, covers a plaster which is stated to contain a "water soluble methyl or ethyl cellulose" (Ex. F, 1/70). In Example 2, however, Heijmer refers to a "water suspension of ethyl cellulose", thus recognizing that ethyl cellulose is not soluble in water, as testified to by two of defendant's witnesses (Stone, 797, and Knesel, 150), and two of plaintiff's witnesses (Wagner, 1400, and Lacey, 375).

Since Heijmer teaches "water soluble methyl and ethyl cellulose" to be equivalents in his plasters, however, he necessarily establishes the use in plasters of a methyl cellulose which is the equivalent of ethyl cellulose, and therefore water insoluble, and therefore not capable of increasing viscosity.

Both Dr. Lacey (1375) and Dr. Wagner (62) testified that water insoluble cellulose ethers such as ethyl cellulose would not work in the dry-set mortars of the patents.

Dr. Stone, defendant's expert, testified that water insoluble cellulose ethers such as ethyl cellulose "swell up" on addition to water and therefore could conceivably be used in dry-set mortar. He, however, had never actually made such a product, and conceded in the same breath that "the further the cellulose ethers are removed from water solubility, the less desirable they become as thin-set mortar components" (832).

In any event, the record is clear that insoluble ethers such as ethyl cellulose would certainly not have the tremendous viscosity increasing capacity called for by the claims of the patents, so that even were mortars made from such an ether, they would not have the water-retentivity properties of the patented compositions.

Kaveler (Ex. P) is directed to an oil well cement comprising Portland cement in combination with "cellulose ethers" of the "methyl cellulose" type.

At column 4, lines 23-25, Kaveler states that the viscosity of a "1% aqueous solution" of his ether is 1 centipoise at 20° C. This means that the cellulose ether in the "1% aqueous solution" referred by by Kaveler did not change the viscosity of the water at all (1343).

But Kaveler's expression "aqueous solution" as a description of his cellulose ethers is identical to Spillman's expression "aqueous solution" for his "methyl cellulose".

Here then is further evidence, if any is needed, that Spillman's mere mention of an "aqueous solution" of methyl cellulose is not a teaching that there is present in the "aqueous solution" a "methyl cellulose" having the viscosity properties taught by the patents.

Mere words which teach the art nothing about the product and do not put anyone in possession of the invention cannot be an anticipation. *Phillips Petroleum Co.* v. *Ladd*, 219 F. Supp. 366 (D.D.C., 1963).

2. Inoperative varieties of methyl cellulose exist and are available.

The existence of many varieties of methyl cellulose which would not be operative to practice the inventions of the patents has been demonstrated, *supra.*

Defendant's contention that all methyl cellulose fits the description given by the patents in suit, accordingly, is simply not true.

On page 2 of Greminger Deposition Ex. 6*, Methocel AS is offered for sale in the United States by the Dow Chemical Company. It is described as a methyl cellulose which "is not water soluble". It has already been shown that methyl cellulose which is not water soluble would not have the viscosity taught by the patents. Thus, the record is also *contra* defendant's contention that methyl cellulose which does not fit the description of the patents is not commercially available.

In its Brief (pp. 16-18) defendant quotes Dr. Wagner out of context in an attempt to prove its point.

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* A brochure of the Dow Chemical Company entitled "The New Methocel Powdered Dow Methylcellulose".

A review of this testimony, however, proves the contrary.

At page 105, Dr. Wagner was asked:

> "Q. And you can, I take it, order from the manufacturer methyl cellulose of a given viscosity. Is that so?"

Dr. Wagner answered this question as follows at 105-106:

> "A. Yes. You may specify any one of a number of different viscosity types or grades when you place an order.
>
> "Q. As to the ones they offer you, you can.
>
> "A. Out of the ones that they offer. And I might cite typical steps.
>
> "Q. Yes, would you, please.
>
> "A. There is a 10-centipoise type. There is a 25-centipoise type. There is a 50-centipoise type. There is a 150-centipoise type; a 400-centipoise type; a 1,500-centipoise type; a 4,000; a 6,000; a 7,000; and more recently I think there have been introduced 13,000-centipoise types."

Thus, when Dr. Wagner gave the viscosity grades of methyl cellulose, he was testifying not as to all types of methyl cellulose that were commercially available, but only to the viscosity graded methyl cellulose that he would order to manufacture the mortars described in his patents.

Immediately before the testimony quoted *supra*, Dr. Wagner clairified this entire point for the trier of fact at 105:

> "In other cases, for uses outside of our discussion, and other very important technical uses, you want not

so much to increase viscosity, but you want some chemical activity for dispersing powers or whatever, and then there you don't care about the viscosity."*

Hence, the record is exactly opposite to defendant's contention that the only methyl cellulose available is that described in the patents in suit.

In any event, the test of anticipation here is not what methyl cellulose is or was available, but whether Spillman "teaches methyl cellulose" which must have the viscosity properties taught by the patents. *Andrews* v. *Wickenden*, 194 F.2d 729, 732 (CCPA 1952). Spillman misses the target. Again he fails the test.

3. Spillman's plaster does not "consist essentially of" the three ingredients specified in the '932 claims.

Claim 1 is typical of the '932 patent. It specifies that the dry composition "consists essentially of" three recited ingredients, namely, 24.8 to 89.8% Portland cement, 0.2 to 6.5% methyl cellulose of 10 to 7,000 centipoise viscosity grade, and about 10 to 75% of at least one substance selected from the group consisting of sand and powdered limestone. The claim further specifies that the dry composition is adapted to be mixed with about 11 to 40% of its weight of water.

The phrase "consists essentially of" is a word of art in patent claims. As was held by the Board of Appeals in *Ex*

* This testimony of Dr. Wagner serves to explain a function of Spillman's methyl cellulose, i.e., it serves as a dispersing agent for polyvinyl acetate. Methyl cellulose is conventionally utilized as an emulsifier or dispersing agent to maintain polyvinyl esters such as polyvinyl acetate in an emulsified state. See Ex. ZZ, page 21. The ratio of methyl cellulose to polyvinyl acetate in the Spillman plasters approximates that ordinarily present in polyvinyl acetate emulsions.

parte Davis & Tuukkanen, 80 U.S.P.Q. 448 (P.O. Bd. App. 1949):

> "Recital of 'essentially' along with 'consisting' renders the claim open only for ingredients which do not materially affect the basic and novel characteristics of the composition."
>
> * * *
>
> "In the present case where the claims recite three ingredients and the reference discloses four, the important question is whether the term 'consisting essentially of' excludes that fourth ingredient. We think that it does, since the 'modifier' materially changes the fundamental character of the three-ingredient composition of claims 13, 14 and 16. * * * we are influenced by the facts that the construction of the term 'consisting essentially of' quoted hereinbefore from the code of the Primary Examiners suits the situation in this case and also that numerous patents have issued using the term in reliance upon the meaning given it in the said code."

Spillman, in addition to Portland cement, "methyl cellulose" of unspecified type, and sand, contains 17.3% by weight of "pulverized chalk whiting" a truly enormous amount of an extraneous "fourth" ingredient not called for by the claims of '932, and therefore excluded by the very terms of the claims.

Further, "chalk" in such amounts is not intended for use in the tile setting mortars of the '932 patent (Ex. AB, p. 25, line 24).*

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* This statement was made with reference to Heijmer (Ex. F), which according to Defendant's Ex. BK, contains 21% by weight of suspended chalk, or substantially the same amount of pulverized chalk whiting called for by Spillman (Ex. J). See discussion, *infra*, page 54.

The reason is clear.

A "pulverized chalk whiting" or "suspended chalk" if present in the mortars of '932 in the amount called for by Spillman (or Heijmer) would interfere with bond strength and change the fundamental character of the three ingredient composition of the '932 claims. As such, its presence in Spillman obviates anticipation under the doctrine of *Ex parte Davis & Tuukkanen, supra.*

4. Spillman does not teach the dry, re-emulsifiable polyvinyl acetate of '382.

Spillman mixes an aqueous suspension or emulsion of polyvinyl acetate with a solid filler portion to produce a paint or plaster. The '382 claims require the presence in the tile mortar composition of dry, re-emulsifiable polyvinyl acetate. The distinction between these two completely different types of polyvinyl acetate is clearly brought out in the '382 patent itself (Ex. 2, 1/62 to 2/10).

Dr. Wagner was partly responsible for the development of the dry, re-emulsifiable polyvinyl acetate necessary for the success of the '382 composition (226) and particularly described by Morrison (Ex. G), a patent cited in the specification of '382 (Ex. 2, 3/48). In the compositions of the '382 patent there is synergism between the dry, water insoluble, re-emulsifiable polyvinyl acetate and the water-soluble methyl cellulose of 80 to 6,000 centipoise viscosity to produce unexpectedly enhanced dry-setting properties for the mortars containing this combination of ingredients (231, 232), in addition to flexibility.

Synergism is defined as "* * * cooperative action of discrete agencies such that the total effect is greater than the sum of the two effects taken independently." *In re Davis & Murdock,* 134 U.S.P.Q. 257, 259 (CCPA 1962).

The fact of synergism is evidence of invention in compositions of matter comprising a plurality of old materials. *Ex parte Abramson,* 72 U.S.P.Q. 239 (P.O.Bd. App. 1947); *Rystan* v. *Warren-Teed Products Co., Inc.,* 92 U.S.P.Q. 419 (N.D. Tex., 1952).

> "Plaintiff contends in any event that the Wach claims are valid even in the absence of proof of 'synergistic action,' while defendants argue to the contrary. Numerous cases are cited and discussed as bearing upon this argument. There is no occasion, however, to enter this discussion because we are of the view that the finding that 'synergistic action' was shown is clearly supported."
>
> *University of Illinois Foundation* v. *Block Drug Co.,* 241 F.2d 6, 12 (7th Cir. 1957).

Defendant contends that there is no difference between the dry, re-emulsifiable polyvinyl acetate of the '382 patent and the emulsion of Spillman. Dr. Stone, its own expert, testified to the contrary:

> "But there are other applications in which it is not practical to handle reemulsified materials; in other words, they do not perform as well. I think, for example, in the paint area, if you were to take a vinyl acetate latex that is used in paint and spray-dry it and sell this as a product, the quality of the paint surface would suffer by rewetting this later on, and this is why paints are sold bulk-wet." (815-816)

Defendant has introduced no evidence to rebut this testimony or to show that an emulsion of polyvinyl acetate would produce the same or a similar synergistic result as does the dry, re-emulsifiable polyvinyl acetate in the mortars of '382. Absent such showings, defendant's arguments on this point amount to mere protestations of counsel, and should be ignored.

5. Spillman does not anticipate the inventions or render them obvious.

As brought out, there exist many distinctions between the inventions and Spillman. At least two important differences are conceded in defendant's Brief (p. 15). Therefore, there is no anticipation under 35 U.S.C. §102,* which requires that the reference must disclose *all* the elements of the claimed combination, or their mechanical equivalents, functioning in substantially the same way to produce substantially the same result. *Williams Iron Works Co.* v. *Hughes Tool Co.*, 109 F.2d 500 (10th Cir. 1940).

Here then the pivotal law around which the question of invention must center is §103.**

The 1966 decisions† of the United States Supreme Court on the application of the rule of "obviousness" under 35 U.S.C. §103 demonstrate that the present invention more than meet the tests of the law. Those tests were expressed by Judge Learned Hand in *Reiner* v. *I. Leon Co.*, 285 F.2d

* Appendix, 2a-3a.

** Appendix, 4a.

† *Graham* v. *John Deere Co.*, 383 U. S. 1, 35-36; *United States* v. *Adams*, 383 U. S. 39.

501, 504 (2d Cir. 1960) (cited with approval by the Supreme Court in *Graham* v. *John Deere Co.**):

> "There are indeed some sign posts: e.g. how long did the need exist; how many tried to find the way; how long did the surrounding and accessory arts disclose the means; how immediately was the invention recognized as an answer by those who use the new variant? In the case at bar the answers to these questions all favor the conclusion that it demanded more intuition than was possessed by the 'ordinary' workers in the field."

Here, too, all of these sign posts lead to the conclusion that the present inventions required more than ordinary skill.

The findings of the lower court on lack of anticipation and non-obviousness were made against a highly complex background of technical facts. Under Rule 52(d), F.R.C.P., this Court is bound by the findings of the court below on technical facts unless those findings are clearly erroneous. *Wahl* v. *Carrier Mfg. Co.*, 358 F.2d 1 (7th Cir. 1966).

6. Spillman does not teach the gist of the inventions.

Defendant in its Brief seeks to divert attention from the substance of the highly meritorious inventions of the patents and the fatal deficiencies in the prior art by playing a numbers game. It argues that, mathematically speaking, certain ingredients specified by the Spillman patent are present in amounts which fall within the quantitative range limits for ingredients recited in the claims.

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* 383 U. S. 1, 36 (1966).

As has been established, Spillman is fatally defective as an anticipatory reference for a variety of reasons, paramount among which is the simple fact that it does not teach the use of "methyl cellulose" component which is capable of increasing the viscosity of water, or the achievement of a water-retentivity property in its paints or plasters. Absent a disclosure of such teachings, which are crucial to the patented inventions, Spillman cannot be seriously considered as an anticipation of the dry-set grouts and mortars which have revolutionized the ceramic tile setting art.

The mere fact that a mathematician can twist and turn Spillman's ingredients until they approach the numerical ranges of the patent claims is irrelevant, since Spillman does not teach the gist of the inventions.

> "* * * We find in the Draeger opinion what we consider the key to determining whether a disclosure supports a claim * * * viz., does the disclosure *teach the gist of the invention* defined by the claims?
>
> While we realize that all limitations of a claim must be considered in deciding what invention is defined, it is futile merely to compare quantitatively range limits and numbers set out in counts with range limits and numbers disclosed in allegedly supporting specification. Closer scrutiny is required to get at the essence of what invention the count purports to define (emphasis the court's) * * *"
>
> *Hall* v. *Taylor*, 332 F.2d 844, 848 (CCPA 1964).

7. The best prior art was considered and rejected by the Patent Office.

The best prior art was considered by the Patent Office and the patents allowed thereover.

The Heijmer (Ex. F) plaster is the full equivalent of Spillman's. Since the Examiner considered Heijmer and allowed '932 thereover,* it can be stated that he also considered the substance of the teachings of Spillman and allowed the '932 patent over such teachings also.

Similarly, the Spillman Australian Patent 166,566 (Ex. 73), which for the most part is similar to the British Spillman patent (Ex. J) [1301], was considered by the Examiner during the prosecution of the '382 patent,** and held not to be a bar.

> "The presumption of validity of a patent is enhanced where best prior art was considered by the Patent Office and resolved in favor of applicant."
>
> *National Sponge Cushion Co.* v. *Rubber Corp. of Cal.,* 286 F.2d 731, 735 (9th Cir. 1961).
>
> "While we have focused attention on the appropriate standard to be applied by the courts, it must be remembered that the primary responsibility for sifting out unpatentable material lies in the Patent Office."
>
> *Graham* v. *John Deere Co.,* 383 U. S. 1, 18 (1966).

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* Heijmer (Ex. F), which is U. S. Patent 2,700,615, was a file wrapper reference against '932. See Ex. 1, 8/35.

** Ex. 2, 8/8, Ex. ZZ, p. 19.

8. Spillman is a foreign patent and must be strictly construed.

Spillman, the only reference which defendant now claims invalidates the inventions in suit, is a foreign patent. Under the law of this Court, it must be strictly construed.

> "A foreign patent is to be measured as anticipatory, not by what might have been made out of it, but by what is clearly and definitely expressed in it. An American patent is not anticipated by a prior foreign patent, unless the latter exhibits the invention in such full, clear, and exact terms as to enable any person skilled in the art to practice it *without the necessity of making experiments* * * *." (Emphasis supplied.)
>
> *Carson* v. *American Smelting & Refining Co.*, 4 F.2d 463, 465 (9th Cir. 1925).

The soundness of this rule was recently re-evaluated and adhered to. *Pursche* v. *Atlas Scraper & Engr. Co.*, 300 F.2d 467, 477 (9th Cir. 1961).

9. The process claims of '932 define new, useful and patentable methods.

Claims 8 and 9 of '932 are directed to the method of installing ceramic tile utilizing the new and improved compositions set forth in the composition claims and containing Portland cement, methyl cellulose of 10 to 7,000 centipoise viscosity grade and sand or limestone.

The revolutionary impact of the dry-set method of installing tile described by these method claims is highlighted, *infra,* and was emphasized by the trial court in its Findings (Findings of Fact, 24 and 27, R. 140-141).

One of the bases for defendant's assertion that the method claims are invalid is Ex. Y, which is a publication by the plaintiff entitled "Genuine Clay Tile." That reference, however, teaches not *dry-setting* of tile, but a modification of the conventional *wet-setting* "mud" technique described above. Page 17 of Ex. Y contains explicit instructions for wetting down both the substrata and the tile themselves.*

The admissions referred to in defendant's Brief, pp. 22-23, each relate to the installation of tile by so-called organic mastics. These materials bear no similarity at all to Portland cement mortars. As found by the trial court:

> "Organic adhesives had the drawbacks that they contained toxic and flammable solvents, they were not durable, they were hard to clean, and they had only fair resistance to water. [19, 73, 74, 75, 76, 78] Also, organic adhesives could not be used in thick enough layers to serve as a leveling medium, because the adhesive would not dry properly." (Findings of Fact, 15, R. 137)

Defendant contends that in considering the patentability of the process claims of '932, the Court must strip away all considerations of the composition and base its decisions

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* "J1. Thin Portland Cement Mortar Setting Bed—Mix mortar by volume in the proportions of one part Portland cement; one-half to one part hydrated lime; and four to seven parts sand. *Immediately prior to applying the mortar setting bed wet (evenly but do not saturate) the surface to which the setting bed is to be applied*" (emphasis supplied).

* * *

"J2. Soaking Tile for Portland Cement Beds—Immerse absorptive unmounted Tile until saturated in advance of laying so that they will not steal moisture from the mortar and result in a weak bond." [Ex. Y, p. 17]

solely upon the remaining process steps. This is simply not the law. As stated by the Commissioner of Patents in *Ex parte Wagner,* 1951 C.D. 3, 8:

> "Many processes which are old in a procedural sense becomes new when, by the use of a different agent, a new result is accomplished".

Here, the use of plaintiff's mortar compositions produces a completely new result—the ability to dry-set ceramic tile (i.e., set without the necessity of wetting down the substrate and/or tile with water) with an inexpensive Portland cement containing composition. Such a result was heretofore not possible. In the face of this record, it is ludicrous to maintain, as does defendant, that the patentability of this highly meritorious and revolutionary tile installing technique is negatived by the fact that tile had been set with organic mastics mixed with organic solvents in the absence of water. Such mastic compositions are simply not analogous to the dry-set Portland cement compositions recited in the method claims of '932.

The second string to defendant's bow on these method claims also turns up out of tune. According to it, the process claims of '932 are not patentable if the composition recited in those claims are old.

The law is *contra.*

Section 100(b) of Title 35 U. S. C.* provides:

> "The term 'process' * * * includes a new use of a known * * * composition of matter or material."

* 35 U. S. C. §100(b) [1952]. Appendix, 2a.

Thus, defendant's argument to the effect that the method claims can only be patentable if they recite a new material cannot be sustained in the face of the express provisions of Section 100(b).

> "The language used in Section 100(b) to define what is meant by the term 'process' is explicit here. It, in our opinion, clearly indicates that it was the intent of Congress to authorize the grant of a patent for a new use, subject of course to the conditions and requirements of the act * * *, when such use is claimed in the form of a process, act or method * * *".
>
> *Ex parte Griffin*, 106 U.S.P.Q. 388 (P.O. Bd. App. 1953).

That a new use of an old composition of matter may be patentable as a method was also established by the Fourth Circuit in *Rohm & Haas Co. v. Roberts Chemicals*, 245 F.2d 693, 699 (4th Cir. 1957).

Of course, the mortar compositions recited in method claims 8-9 are specifically new, as has already been demonstrated. But plaintiff is not prejudiced by that fact. To the contrary, since under Section 100(b), a new use of an *old* composition of matter is clearly patentable, it must necessarily follow that a new use for a *new* composition is also patentable under that section.

Thus, regardless of whether the compositions of '932 are new or old, the method claims of '932 are patentable over Graf (Ex. Y), the only reference asserted against these claims, and over the prior art organic mastic technique for the installation of tile.

Where the method satisfies an old and recognized want, invention will be inferred rather than the exercise of

mechanical skill. *Kaakinen* v. *Peelers Co.,* 301 F.2d 170, 173 (9th Cir. 1962).

10. The method claims of '382 are patentable.

The method claims of the '382 patent constitute a description in process terms of the same invention which is described by other claims in terms of composition of matter. Since 35 U. S. C. §101* clearly provides statutory basis for both "process" and "composition of matter" inventions, such claims are clearly proper, where, as here, they appear in a single patent with the composition claims. *In re Conover,* 134 U.S.P.Q. 238 (CCPA 1962); *Ex parte Bartelson, Breneman and MacAdam,* 151 U.S.P.Q. 59 (P.O. Bd. App. 1966).

11. The inventions satisfied long-felt and unsolved needs and met with immediate success.

With the utter failure of the prior art to supply the needs of the industry, and with the many advantages proved for the mortars of the patents, it is to be expected that they would meet with resounding success in the tile-setting industry. This is exactly what happened. The products were immediately, widely, and successfully marketed by licensees of the Tile Council, they became a standard technique for setting ceramic tile, and the most widely one used, they displaced to a large extent existing techniques, they were uniformly acclaimed as supplying a long-felt need in the industry, even the individual who is president and guiding force of the defendant corporation joined in the fulsome praise accorded the products, and he followed the

* Appendix, 2a.

compliment with action by copying and marketing the products as his own.

Some 12 companies have asked for and been granted licenses to make the products since 1957 (21, 352). Sales of products by these licensees covered by the '932 patent* to and through the third (3rd) quarter of 1964 amounted to about Two Million Dollars ($2,000,000) (353).

This is the sale of some forty-two million (42,000,000) lbs. of mortar which would set eighty-two million (82,000,-000) square feet of ceramic tile (356). Savings in labor and material costs to the industry over use of the mud method for this amount of tile would be some Sixteen Million Dollars ($16,000,000) (357).

The American Standards Association, an organization which sets quality standards for products which are in general usage in American industry, has prepared and published standards for dry set mortars (27, Exs. 6, 7).

The presumption of validity which attaches to an issued patent is strengthened by such commercial success; *Stearns v. Tinker & Rasor*, 220 F.2d 49, 58 (9th Cir. 1955); *Coleman Co. v. Holly Mfg. Co.*, 233 F.2d 71, 80 (9th Cir. 1956), *cert. denied*, 352 U. S. 952 (1956); *Neff Instrument Corp. v. Cohu Electronics, Inc.*, 298 F.2d 82, 87 (9th Cir. 1961).

* Although the Tile Council has provided its licensees with formulae including polyvinyl acetate (Ex. 55), the flexible mortar has not been widely sold by the licensees. The figures proved by plaintiff for commercial success are therefore generally confined to the '932 patent. Commercial success for the '382 patent is evident, of course, from the seven different products made and sold by defendant which were proved to infringe (R 157).

The dry set method became the most prominent technique for the installation of tile, and organic adhesives were largely replaced (161-2). Some manufacturers such as Mr. William Love of L&M Tile Products, Inc. of Dallas, Texas, a man representing the third generation of his family in the tile business, stopped producing earlier tile-setting materials and turned entirely to the production of the new products as a licensee of the Tile Council (381-84). Earlier methods of using relatively thin setting beds for the setting of tile, as described in a booklet which the Tile Council had published to the industry in 1952 (Def. Ex. Y) were very largely rendered obsolete (1397, 1434-35). The instant recognition of the product and that it drove notable predecessors from the field are important indicia of invention; *Schering Corp.* v. *Gilbert,* 153 F.2d 428, 431 (2d Cir. 1946).

The proof is extensive and uniform that the Tile Council's mortar development was badly needed in the industry at the time it came along, and that it fully met the existing problems. Mr. Love said the mortar of the '932 patent "was something our industry was searching for, and we found", and that it had a "tremendous" impact in the business (384). Edward McGourty, a witness called by the defendant, had been in the tile business for forty-three (43) years at all levels of employment, including business manager of the Tile Layers Union in the Los Angeles area (1214). He agreed that in 1955 there was a need in the industry for a mortar that would set dry tile on dry substrate (1239). The defendant, in the advertising of its infringing products, called the thin-set development "a revolutionary new method of setting tile" (129, Ex. 19, p. 314).

Where the method or device satisfies an old or recognized want, invention will be inferred rather than the exercise of mechanical skill; *Kaakinen* v. *Peelers Co.*, 301 F.2d 170, 173 (9th Cir. 1962); *Stevenson* v. *Lamson Corp.*, 210 F.Supp. 917, 918 (N. D. Cal. 1962). Where problems are unmet in an industry and men of ordinary skill have failed to meet them, it is evidence of invention; *Moist Cold Refrigerator Co.* v. *Lou Johnson Co.*, 249 F.2d 246, 253-54 (9th Cir. 1957). Tribute to the patent by major manufacturers in the industry involved is very persuasive that a patent is valid; *White* v. *Tak-Trak Inc.*, 140 USPQ 156, 164 (S. D. Cal. 1963).

The mortar development of the Tile Council was widely mentioned in the press of the day (25, 26, Exs. 3, 4, 5, 8), but it remained for Mr. Lester Knesel, president of the defendant, to deliver the highest encomium to the work. We quote in a footnote below at some length from an article of Mr. Knesel in the trade magazine "Tile" published in January, 1958 (Ex. 11), since we have seen no better statement anywhere of the dramatic nature of the inventions here in suit.*

* "Far back in history European craftsmen used thin coats of cement for adhering tiles. Today various thin setting bed methods are being used by Europeans extensively. In the United States, we find in patent literature, many cementitious compositions for use as thin setting beds. Some of these date back 30 years. All had many shortcomings, but the basic idea was appealing. A gypsum compound was marketed throughout the United States some 18 years ago. It had wide acceptance, but poor adhesion coupled with an adverse coefficient of expansion soon doomed this material.

"This limited start was the signal for organic adhesives to move into the field. These materials did good jobs in many instances but their wholesale use over badly prepared surfaces accounted for a lot of poor installations. However, the installing of ceramic tile by the organic adhesive method increased the use of tile many fold, by pric-

The article appeared in January, 1958 (165). The Tile Council's first licensee had received its license in April, 1957, and began to produce the products (382, 383).

Dr. Wagner, a man working very actively in the field, said he did not know of any other work than that of the Tile Council which was done along the scientific lines Knesel described to develop dry-set mortar (168). The necessary conclusion is that Knesel was paying tribute in his article to the work of the Tile Council. Mr. Knesel attended throughout the trial of the case, he listened to Dr. Wagner testify as above, he testified at length after such testimony of Dr. Wagner, and he never denied this conclu-

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ing it in line with the flood of tile imitations that hit the market at the close of World War II.

"In the latter part of this period Portland cement admixed products made their appearance. Some were dry admixes, while others were wet admixes. I know that many of you are familiar with them. Some forms of these and organic adhesives are still being used very extensively today. All of these various efforts were pointing *to an ultimate cement composition* that would perform as desired.

"During this latter period, research was going on to find a cement-based product that would possess all of the properties desired for a thin set cement mortar. *Fortunately the world of chemistry was also making remarkable progress. As the researchers coupled Portland cement and modern chemicals some amazing results began to appear. Dry tiles were being set on dry backing.* Materials are now on the market embracing these principals that we are sure will be a most valuable tool in the ceramic tile industry."

* * *

"Now, our problem was to furnish a cementitious composition with these optimum conditions, adhesion, open time, shrinkage, water resistance, hardness and resilience. We are happy to state that such compositions are now available for your use. Now let's take a look at the type of reaction we encounter. *Thin Set Adhesive Mortars* can be considered dual reaction compounds. *On one side we have the water holding super adhesive phase. Now, we must balance one reaction against the other, to obtain a material with the desired workability and durability.*

"Through *valient* (sic) *research* it appears that most of these questions have been answered." [Emphasis supplied.]

sion. With no scientific background (Admitted Fact 28, R 92), it is clear Mr. Knesel was not describing his own work.

It seems impossible that this is the party who now contends that the thin-set dry-set mortar and method were long available to his industry in the teachings of various plaster, spackle, paint and oil well cementing patents. The explanation may be that it was several years later, in 1960, that the '932 patent issued, and the defendant was made aware that some compensation might be due for the contribution of the "ultimate cement composition" to the industry.

The Supreme Court has indicated that such evidence as here presented is very pertinent in supporting patentability.

> "And, further, that the long-felt need in the industry for a device such as Scoggin's together with its wide commercial success supports its patentability. These legal inferences or subtests do focus attention on economic and motivational rather than technical issues and are, therefore, more susceptible of judicial treatment than are the highly technical facts often present in patent litigation [citing authority]. Such inquiries may lend a helping hand to the judiciary which, as Mr. Justice Frankfurter observed, is most ill-fitted to discharge the technological duties cast upon it by patent legislation [citing case]. They may also serve to 'guard against slipping into use of hindsight,' [citing case] and to resist the temptation to read into the prior art the teachings of the invention in issue."
>
> *Graham* v. *John Deere Co.*, 383 U. S. 1, 35-36 (1966).

II. THE PATENTS HAVE BEEN INFRINGED.

The findings of infringement are supported by the overwhelming weight of the evidence. The errors assigned in Defendant's Brief (p. 11) are incredible in the light of the record.

A. The Use of Dow Methocel HG Does Not Avoid Infringement.

The accused products are described in Ex. 15-1 to 15-9. In their manufacture, defendant utilized Methocel, Grade HG, purchased from the Dow Chemical Company. It had a viscosity rating of 400 centipoises or 4,000 centipoises, measured in 2% aqueous solution [Ex. 16, Defendant's Admissions 4 and 4(a)].

"Methocel" is a registered trademark of Dow Chemical Company for "methyl cellulose" (Ex. 49).

The term "methyl cellulose" is also used by Dow to describe the product referred to in its Methocel brochures as methyl hydroxypropyl cellulose (Greminger Deposition, Ex. AD, pp. 58, 62).

Dow's methyl and methyl hydroxypropyl cellulose ethers are sold under the trade name Methocel, the former being designated MC Grade, and the latter being designated HG Grade (Greminger Deposition, Ex. AD, p. 9).

In Methocel HG products, the methoxyl substitution is the major added substituent, comprising 84.0 to 93.3% of the groups added to the cellulose ring. The amount of methoxyl by weight is about in the same range for the

Methocel HG Grade as for MC Grade (Greminger Deposition, Ex. AD, pp. 94-95).

Further, the term "methyl cellulose" is also used by Dow to refer to both the simple methyl ethers of cellulose (Methocel MC) and a mixed ether of cellulose in which methyl is the predominant constituent group (e.g., Dow Methocel HG) [Greminger Deposition, Ex. AD, pp. 58, 62, 125-126].

On this record, an equivalency question is not even raised, since Dow Methocel HG used by plaintiff is *in fact* the "methyl cellulose" of the patent claims, and by defendant's own admission has a viscosity rating of 400 centipoises or 4,000 centipoises, both of which viscosities fall well within the ranges called for by the claims of both patents.

But even viewing HG Grade Methocel as a modified form of methyl cellulose, it is the full equivalent of the methyl cellulose called for by the patent claims.

Thus, Methocel HG is a water-soluble polymer which is similar in most properties to Methocel MC, but differs from methyl cellulose in that it has a high gelation temperature, a property which would not affect its ability to perform as a viscosity increasing agent in the composition of the patents in suit (106). Wagner used both MC and HG Grades of Methocel in developing his inventions (107).

Dow itself has published a brochure (Greminger Deposition Ex. 7)* which specifically prescribes the use of both

* Page 3 of this brochure is reproduced at Appendix, 6a to 7a.

Methocel HG and Methocel MC for use in practicing the inventions of the patents in suit.

On the critical feature of water-retentivity or water absorption, Methocel HG and MC have the same order of performance (Greminger Deposition, Ex. AD, p. 341).

The sacks (Ex. 67) in which the infringing products have been sold establish beyond doubt that the products are intended for the dry-setting and grouting of tile and in use function in the same way as products made under the patents in suit. Further, Mr. Knesel, defendant's President, admitted (544) that he was forced to put out his dry-set line of products by the appearance on the market of dry-set products licensed by plaintiff.

Thus, the trial court properly found that:

> "* * * The HG product of Dow Chemical used by defendant is an equivalent of the methyl cellulose disclosed by the 932 patent" (Opinion, p. 3, R 129).

In a recent case of a patent dealing with whippable emulsions, the finding by a lower court that hydroxypropyl methyl cellulose was the equivalent of methyl cellulose was upheld by the Second Circuit.

> "While the use of this ingredient by the appellants makes a slight technical variation from the language of Claim Four, there was sufficient support in the record for the trial court's conclusion that 'the substituted cellulose used by the defendants is the chemical and functional equivalent of methyl cellulose and methyl ethyl cellulose, which are specifically described in the patent in suit.' "

Rich Products Corp. v. *Mitchell Foods, Inc.*, 357 F.2d 176, 183 (2d Cir. 1966).

This is the identical conclusion reached by the lower court in the present case.

> "The doctrine of equivalents evolved in response to this experience. The essence of the doctrine is that one may not practice a fraud on a patent. * * * a patentee may invoke this doctrine to proceed against the producer of a device 'if it performs substantially the same function in substantially the same way to obtain the same result.' "
>
> *Graver Tank & Mfg. Co.* v. *Linde Air Products Co.*, 339 U. S. 605, 607-8 (1950).

The doctrine is of course followed by this Court. *Hansen* v. *Colliver*, 282 F.2d 66 (9th Cir. 1960).

B. Defendant Has Produced and Sold the Dry-Set Grouts and Mortars of the Patents in Suit—Not the Oil Well Cement Slurries of Kaveler.

Defendant's attempt to escape the finding of infringement on the ground that he is practicing Kaveler (Ex. P) and not the patents in suit is sheer fantasy. Kaveler has nothing whatsoever to do with grouts or mortars for setting ceramic tile. It contains no recognition of the problems faced by the tile industry on the eve of the inventions. Nor does it suggest any solution to those problems, let alone the solutions embodied within the patents in suit.

Kaveler is directed to slurries for the cementing of oil wells, a problem which is unrelated to that of dry-setting and grouting ceramic tile (1261).

One advantage of Kaveler's slurry, as stated by the patent itself, is that it is a *low viscosity,* retarded set slurry (Ex. P, 3/13-16).

Although, as brought out *supra,* Kaveler describes the use of cellulose ethers in his slurries, at least one of which could be considered a modified "methyl cellulose", Kaveler's cellulose ethers must be water insoluble, since they produce no effect on the viscosity of water (1343, Ex. P, 4/19-25).

The methyl cellulose specified for use in the patents in suit is not the water insoluble form of "methyl cellulose" described by Kaveler, but the water-soluble form which is capable of exerting a tremendous increase on the viscosity of water. When defendant formulated its products, it utilized not the insoluble cellulose ether of Kaveler, which produces no change in the viscosity of water, but Methocel HG, which was capable of increasing the viscosity of water either 400 times or 4,000 times.

The degree of substitution for the alkyl and hydroxyalkyl groups are similar in the cellulose ethers of Kaveler, as established by the formulae at the bottom of column 3, wherein the degree of substitution of the alkyl and hydroxyalkyl groups are shown to be the same. Dr. Lacy also testified that this was so at 1226-1227.

As distinguished from such mixed cellulose ethers, the Methocel HG utilized by defendant contains predominantly methyl groups, i.e., 84.0 to 93.3% by weight of the substituent groups added to the cellulose ring are methyl groups,

the remainder being hydroxypropyl groups (Greminger Deposition, Ex. AD, p. 94).

In the light of this record, defendant cannot sustain the position that he is simply practicing Kaveler. That patent teaches directly away from the inventions of the patents in suit and the infringing products.

III. DEFENDANT COPIED.

The trial court in its opinion said that "* * * the evidence supports the inference that defendant copied plaintiff's compositions and methods" (R 129), and found this as a fact in Finding No. 33 (R 142). The inference of the court and the finding is very amply supported by the record.

The new mortar and method were immediately and widely successful after their introduction to the commercial market in 1957 (161). L&M Tile Products, Inc. of Dallas, Texas, was licensed in April of 1957 and then started to produce the Tile Council formulas (383). Mr. Knesel admitted that he was impelled to put out his dry-set products by the appearance of other such products on the market (544). Mr. Knesel's first commercial dry-set product was sold in October, 1957 (560).

Mr. John Schirm warehoused on the West Coast the first of the L&M licensed mortar which was shipped west of the Rocky Mountains (1105). Mr. Schirm also said (on cross-examination in correction of earlier statements) that sometime in 1956 he opened negotiations at his own instance and request with the Tile Council looking toward

the issuance of a license (1109-10). In the course of this negotiation he was furnished both with a sample of dry-set grout and with a dry-set grout formulation emanating from the Tile Council (1102). Later on, he refused to take the license offered, stating as his reasons (1102) facts at total variance with those he had stated to the Tile Council when he opened the negotiations with it (Ex. 72, 1st par. See discussion *infra*, p. 61). Mr. Schirm must be counted as a good friend of Mr. Knesel. He testified overenthusiastically (to say the least of it) at the trial for defendant.

It therefore appears that defendant had access on the open market to the L&M licensed product before defendant produced its first commercial product. Defendant also had specific access to the L&M product which Mr. Schirm warehoused on the West Coast. It also had access through Mr. Schirm to both the dry-set grout sample and the formula he had obtained from the Tile Council in the course of what the Council thought were *bona fide* negotiations for a license.

It does not tax reason to conclude that the defendant exploited one, two, or all, of these avenues to the Tile Council work.

We have already noticed above the praise Mr. Knesel lavished upon the "valiant research" of the Tile Council in 1958 prior to the issuance of the patents in suit.

Against this, defendant's Brief asserts the policy of the Tile Council to keep its developments secret. This, of course, is not inconsistent with the furnishing of samples and formulae in confidence to negotiate license agreements, and the marketing of licensee's products.

Defendant also asserts (Brief, p. 46) that in January, 1958, it was not known that sand or limestone was a necessary ingredient of the mortar, citing page 22 of the file history, Ex. AB. This page of the file history does *not* carry the quotation defendant makes. Instead, that page directly rebuts defendant's statement, because applicant there reviews for the examiner the pending claims in the case, including numerous mortar composition claims which include sand or limestone. The fact is that there were numerous such claims in the application at and after filing of the application on September 30, 1957, and Dr. Wagner as of that time appreciated the essential nature of sand and limestone in the invention which was patented (1441).

Contrary to defendant's contention, the accused products could have been copied from those commercially launched by the Tile Council, and it is submitted that the evidence overwhelmingly supports the court's conclusion that they were. Adoption of the patented device by the defendant is evidence of invention; *The Troy Co. v. Products Research Co.*, 339 F.2d 364, 367 (9th Cir. 1964); *Stevenson v. Lamson Corp.*, 210 F. Supp. 917, 918 (N. D. Cal. 1962).

IV. THERE WAS NO FRAUD.

The argument of defendant is based upon assertedly conflicting statements of the patent solicitor made at pages 25 and 35 of the file history (Ex. AB) of the '932 patent. Defendant is unsupported by the facts. Both statements are true.

The solicitor at page 35 of the file history said "The results [of shear bond tests submitted to the examiner]

clearly demonstrate that the inclusion of sand or limestone is necessary for proper functioning of the present invention''. This statement is true. The tests did show a very substantial advantage in bond strength in setting vitreous tiles with a composition of Portland cement, sand or limestone, and methyl cellulose, over similar mortars without sand or limestone. The "present invention" to which the solicitor was referring was that covered by the claims then pending, which were the very claims later issued in the patent. These claims cover compositions of Portland cement, sand or limestone, and methyl cellulose. The statement was in all respects true.

In the second statement at page 25 of the file history, the solicitor was distinguishing over the references Ruthman et al. and Heijmer. He pointed out that the Ruthman patent did not teach Portland cement and that "Heijmer's plasters must contain chalk and may also contain pumice". He went on to make the statement that "They are not intended as mortars for setting tile or masonry and are not usable as such".

Defendant's elaborate argument of falsity in this statement is based upon the premise that "The Council's expert established the identity of 'chalk' and 'limestone' " (Brief, p. 28). This premise is not true, and the defendant's entire position falls with it.

Dr. Lacey testified only that chalk and limestone are similar to the extent that "chemically" they are both essentially calcium carbonate (288-89). But Dr. Lacey did not testify that chalk and limestone are physically equiva-

lent for use in a mortar, and the record is clear that they are not. Chalk is not physically suitable as the grained aggregate in the Wagner mortar, and Heijmer with a large percentage of chalk would not give the mortar of the invention.

Dr. Wagner, in speaking of the composition of the mortar, uniformly referred to the use of a "grained aggregate". "I used a porous *grained* aggregate, such as sand or limestone" (63). "In some of its aspects it (the '382 patent) involves also the addition of sand, limestone or other *grained* type of aggregate" (93). "The '932 patent dealt with cement, methyl cellulose and a *grained* aggregate such as sand or limestone as a composite composition" (193).

The mechanism of the use of such grainy material as sand in the mortar was explained by Dr. Lacey.

> "If you add to this mixture *granular material,* inert material, *like sand,* the Portland cement particles are wetted—Portland cement particles surround the *sand grains* and fill in the interstices between the *sand grains* which are rigid, and in this way the shrinkage of the cement can occur without pulling particles apart, because the shrinkage can take place in *the interstices between the sand particles* rather than between the sand particles themselves" (287).

The effect of limestone called for by the patent would be similar, he said (287-88).

Dr. Lacey further testified that materials with particle sizes greatly smaller than sand would not be used in the

mortar. This would be true of titanium dioxide which would have a very fine particle size.

> "Q. Would this act like sand in a cement mix, if you know? A. No. Sand would be of a *different particle size* and therefore they would not be equivalent, unless they were of *the same particle size.* Because these materials are inerts, and therefore *they would be only equivalent when of comparable particle size*" (343-44).

Chalk is not similar in particle size to sand, by common knowledge. As a matter of fact, the Heijmer patent speaks of "suspended chalk" (Ex. J, 1/80), which means chalk of such fineness as will remain suspended in water. This certainly is not material of the particle size of sand aggregate usable in mortar for the purpose shown above.

Dr. Wagner indicated that only small percentages of carefully chosen ingredients might be added to his combination of cement, methyl cellulose and aggregate and still retain its identity (198-99). Certainly large amounts cannot be added within the claim definition which calls for a dry mortar composition which "consists essentially" of those three ingredients. The Heijmer Example 2, even assuming it otherwise taught a Wagner mortar composition, which it clearly does not, in calling for "10-30 parts chalk" would include far too much extraneous material to qualify.

All statements to the Patent Office were true, and defendant's charge of fraud is entirely contrived. The record is utterly devoid of the intentional misrepresentations but for which the patent would not have issued, which defendant must prove by clear, unequivocal and convincing evi-

dence, to justify its charge of fraud. *Baldwin-Lima-Hamilton Corp. v. Tatnall Meas. Sys. Co.*, 169 F.Supp. 1, 25 (E.D. Pa. 1958), aff'd 268 F.2d 395, cert. den. 361 U. S. 894.

The defendant's argument, based upon a fatally defective premise, is further characterized by errors which we are obliged to correct.

At page 25, and again on page 27, of the brief, defendant asserts that Dr. Lacey admitted that Heijmer disclosed a formula within the scope of the patent in suit. This is not true. Dr. Lacey specifically denied it.

> "Example 2 calls for ethyl cellulose. And if that is the case, that would not fall within the scope of the patents in suit, being a relatively insoluble cellulose ether instead of a soluble cellulose ether." (1375)

Dr. Lacey also denied that ethyl cellulose, the material specified in Example 2 of Heijmer, is the equivalent of methyl cellulose: "I don't think the two are equivalent * * *" (1376). There is no justification whatever for defendant's statement that "The patent then proceeds to give two exemplary recipes, one of which falls within the range of the suit patent as stated by the Council's patent expert:" (Brief, p. 27).

Immediately following this statement on page 27 of the brief, defendant says: "Facing the formidable teachings of the Heijmer reference, in prosecuting their patent, the Council eliminated recitations of 'chalk' and 'limestone' from the claims then being urged, and argued:" This quoted passage from the brief is also not true. At this time (Ex. AB, p. 21) there were pending in the application

some 9 claims which included in the claimed composition sand or limestone, or limestone alone. (Claims 1, 5, 10, 12, 13, 14, 15, 17, 21, Ex. AB, pp. 14-17). The claims presented to the Patent Office never included a reference to chalk, and no recitation of limestone was eliminated from the claims at that or any other time. The statement and the argument it makes is complete fiction.

At the bottom of page 27 and top of page 28 of the brief is the assertion that sand or limestone was added to the claims, inferring a change of position by the applicant. This is not true. As shown above, numerous claims were present in the application throughout the prosecution which included sand or limestone in the composition.

It is submitted that the defendant's charge of fraud is so spectacularly baseless, as to do the defendant no credit whatever.

V. THE AWARD OF COSTS AND CONSIDERATION OF MULTIPLE DAMAGES ARE FULLY JUSTIFIED.

The Court below gave the Master permission to recommend the increase of damages up to three (3) times the amount found or assessed under *35 U. S. C. §284** on the basis both of "the willful, intentional and deliberate infringement by defendant and the inequity in its defense" (Conclusion of Law 41, R 162). Both of these grounds were present in this case, and either would be sufficient to base the Court's award.

We have already shown that the Court's finding of willful and deliberate infringement is fully justified on the

* Appendix, 5a.

record. Multiple damages could have been awarded on this basis alone; *Coleman Company* v. *Holly Mfg. Co.*, 269 F.2d 660, 666 (9th Cir. 1959); *Solex Laboratories* v. *Graham*, 165 F.Supp. 428, 437 (S. D. Cal. 1958); *British Laboratories* v. *Schenley Laboratories*, 117 F.Supp. 67, 81 (S. D. Ind. 1953).

Inequitable conduct in connection with the trial also is a proper basis for the award of multiple damages; *Grant Paper Box Co.* v. *Russell Box Co.*, 106 F.Supp. 616, 619 (D. Mass. 1952), aff'd 203 F.2d 177. See *Young* v. *General Electric Co.*, 96 F.Supp. 109, 141 (N. D. Ill. 1951). And, there assuredly was more than enough of that ingredient in the present case.

The trial court found that "very serious discrepancies in statements of fact existed in the testimony given" by four (4) witnesses testifying on behalf of the defendant (Finding of Fact 55, R 149). The defendant put on twelve (12) persons in all, so that the truthfulness of one-third (⅓) of all witnesses produced was seriously compromised. Without attempting to review the extensive record which justified the Court's Finding 55, which has not been questioned in defendant's brief, we will point out the gravity of this activity at the trial.

Lester M. Knesel, president of defendant purported to give a physical demonstration to the Court of the solubility, and usability in mortar, of ethyl cellulose. This was designed to establish the reference Heijmer as an anticipation to invalidate the '932 patent (even though the Patent Office had considered and discarded the reference). On cross-examination, Mr. Knesel admitted he was *not* using ethyl cellulose, which he knew to be *insoluble* in water, but "To

be real true'' he was using hydroxyethyl cellulose, a soluble material (R 150).

This was testimony at the very heart of the case aimed at destruction of plaintiff's patents, and the testimony was knowingly false.

Mr. Paul E. Matheny, chief chemist for a chemical testing laboratory in Los Angeles, rendered a report to defendant for the purpose of this litigation. The testimony and the report left the impression that Matheny had derived certain formulations given in the report from prior art patents. It developed on cross-examination, however, that the formulae were *not* shown in the prior art patents, but had been prepared by Mr. Matheny in collaboration with Mr. Knesel. The trial court, hearing the testimony and observing the witness, said that the testimony ''is hardly a true statement of fact'', and that ''It is objectionable for Mr. Matheny to testify in this fashion'' (R 151).

This was false proof aimed also at the core issue in the case, and perpetrated by a kind of scientific witness upon which courts frequently must place reliance in cases of this kind.

George N. Lavenberg gave testimony designed to show that mortar made by a licensee of plaintiff had been responsible for a serious tiling failure in the beautiful Department of Water & Power Building which, at the time of trial, was just being completed on the hill in Los Angeles Civic Center. It turned out on cross-examination, however, that a written report of Mr. Lavenberg which he had made prior to his appearance at the trial and which he thought was not avail-

able to plaintiff (1003), did not attribute the failure to the mortar, and another witness produced by defendant testified that there was in fact no failure of the mortar (R 151, 152).

This deceitful testimony of Mr. Lavenberg was aimed at neutralizing the overwhelming and otherwise unanimous proof of utility, commercial success and trade acclaim which attended the inventions.

Mr. John Schirm also was called by defendant to testify in derogation of the patented products. He said he had been approached by the Council asking him to take a license, that he was furnished a sample, and that he rejected the license because "we had developed the technology to a farther (*sic*) extent" (1102).

On cross-examination, however, Mr. Schirm was obliged to recant, and to admit that he had in fact first solicited a license from the Tile Council (1109), having done so in his letter of April 12, 1956, to the Research Director of the Council (Ex. 72) in these words:

> "We have followed your work in the development of a new tile grout and feel that an important contribution to the industry has been achieved. We are anxious to participate in the commercial development of the product."

Mr. Schirm's testimony-in-chief thus included a totally false attack upon the utility of plaintiff's product.

It is submitted that the record fully supports the conclusion of inequitable conduct on the part of defendant, and

the court below did not abuse its discretion. See *Talon, Inc. v. Union Slide Fastener, Inc.*, 266 F.2d 731, 739 (9th Cir. 1959). This alone could serve as a reason for the award of multiple damages. The award of costs usually follows the finding of infringement, and surely cannot be questioned in this case.

CONCLUSION

It is respectfully submitted that no error has been shown in the proceedings of the trial court, and that the judgment should be affirmed in all respects.

Respectfully submitted,

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APPENDIX

TABLE OF EXHIBITS

	Identified	*Offered*	*Received*
	Identified	*Offered*	*Received*
Ex. 1	14	14	14
Ex. 2	14	14	14
Ex. 3	26	26	26
Ex. 4	26	26	26
Ex. 5	26	26	26
Ex. 6	28	28	28
Ex. 7	28	28	28
Ex. 8	26	26	26
Ex. 11	164	164	164
Ex. 16	99–100	100	100
Ex. 19	132	132	132
Ex. 30–4	78	78	79
Ex. 30–5	78	78	79
Ex. 30–6	78	78	79
Ex. 30–7	78	78	79
Ex. 49	398	398	400
Ex. 67	144	144	144
Ex. 72	1108	1110	1110
Ex. F	475	475	475
Ex. G	475	475	475
Ex. J	475	475	475
Ex. P	475	475	475
Ex. Y	479	479	479
Ex. AB	485	485	485
Ex. AD	904	904	904
Greminger Dep. Ex. 6	904	904	904
Greminger Dep. Ex. 7	904	904	904
Ex. BK	855	861	861
Ex. ZZ	485	485	485

Appendix

Excerpts from Patent Statute, 35 U. S. C.

§100. Definitions

When used in this title unless the context otherwise indicates—

(a) The term "invention" means invention or discovery.

(b) The term "process" means process, art or method, and includes a new use of a known process, machine, manufacture, composition of matter, or material.

(c) The terms "United States" and "this country" mean the United States of America, its territories and possessions.

(d) The word "patentee" includes not only the patentee to whom the patent was issued but also the successors in title to the patentee.

§101. Inventions patentable

Whoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title.

§102. Conditions for patentability; novelty and loss of right to patent

A person shall be entitled to a patent unless—

(a) the invention was known or used by others in this country, or patented or described in a printed publication

in this or a foreign country, before the invention thereof by the applicant for patent, or

(b) the invention was patented or described in a printed publication in this or a foreign country or in public use or on sale in this country, more than one year prior to the date of the application for patent in the United States, or

(c) he has abandoned the invention, or

(d) the invention was first patented or caused to be patented by the applicant or his legal representatives or assigns in a foreign country prior to the date of the application for patent in this country on an application filed more than twelve months before the filing of the application in the United States, or

(e) the invention was described in a patent granted on an application for patent by another filed in the United States before the invention thereof by the applicant for patent, or

(f) he did not himself invent the subject matter sought to be patented, or

(g) before the applicant's invention thereof the invention was made in this country by another who had not abandoned, suppressed, or concealed it. In determining priority of invention there shall be considered not only the respective dates of conception and reduction to practice of the invention, but also the reasonable diligence of one who was first to conceive and last to reduce to practice, from a time prior to conception by the other.

§103. Conditions for patentability; non-obvious subject matter

A patent may not be obtained though the invention is not identically disclosed or described as set forth in section 102 of this title, if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains. Patentability shall not be negatived by the manner in which the invention was made.

§282. Presumption of validity; defenses

A patent shall be presumed valid. Each claim of a patent (whether in independent or dependent form) shall be presumed valid independently of the validity of other claims; dependent claims shall be presumed valid even though dependent upon an invalid claim. The burden of establishing invalidity of a patent or any claim thereof shall rest on the party asserting it.

The following shall be defenses in any action involving the validity or infringement of a patent and shall be pleaded:

(1) Noninfringement, absence of liability for infringement, or unenforceability,

(2) Invalidity of the patent or any claim in suit on any ground specified in part II of this title as a condition for patentability,

(3) Invalidity of the patent or any claim in suit for failure to comply with any requirement of sections 112 or 251 of this title,

(4) Any other fact or act made a defense by this title.

In actions involving the validity or infringement of a patent the party asserting invalidity or noninfringement shall give notice in the pleadings or otherwise in writing to the adverse party at least thirty days before the trial, of the country, number, date, and name of the patentee of any patent, the title, date, and page numbers of any publication to be relied upon as anticipation of the patent in suit or, except in actions in the United States Court of Claims, as showing the state of the art, and the name and address of any person who may be relied upon as the prior inventor or as having prior knowledge of or as having previously used or offered for sale the invention of the patent in suit. In the absence of such notice proof of the said matters may not be made at the trial except on such terms as the court requires. (Amended July 24, 1965, Public Law 89-83, sec. 10, 79 Stat. 261.)

§284. Damages

Upon finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement but in no event less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs as fixed by the court.

When the damages are not found by a jury, the court shall assess them. In either event the court may increase the damages up to three times the amount found or assessed.

The court may receive expert testimony as an aid to the determination of damages or of what royalty would be reasonable under the circumstances.

Exhibit 7 to Greminger Deposition, AD, Page 3

Dry, powdered Methocel product may be conveniently added to a ball mill when it is charged. Wet milling for several hours will be sufficient to attain complete water solution of the particles.

Because of the surface activity of Methocel products, foaming is occasionally a problem and may be controlled by the use of a defoamer such as Dow polyglycol P-1200. A ration of two parts polyglycol to one part of Methocel powder is ordinarily effective. Occasionally, incorporation of a Methocel product retards the drying rate of the applied glaze. This may be compensated for by reducing the water content of the mix or by replacing part of the water with alcohol.

Tile Mortar and Grout

Advantages

High viscosity Methocel products are uniquely useful as water retention agents which make possible certain patented methods for installing ceramic tile.*

Older methods of installing such tile required pre-soaking. Unless this was done, the porous tile absorbed water from the Portland cement and prevented proper curing. The result was a mortar with poor adhesion and a grout which exhibited shrinking and cracking.

---

* U. S. Patents 2,820,713, 2,838,411, *2,934,932,* 2,959,489 and *2,990,382,* H. B. Wagner (to Tile Council of America) 1958.

Appendix

With the incorporation of a Methocel product, these difficulties disappear. Methocel products possess excellent water retention properties combined with complete non-reactivity toward Portland cement. The mortar produced has excellent plasticity. Its strength is exceptional, and a 1/16 inch application offers the possibility for a substantial reduction in application costs over the use of a ½ inch bed of conventional mortar reinforced with steel mesh. No pre-soaking is required. Grout made with a Methocel product likewise forms good solid joints without pre-soaking.

Use Information for Tile Mortar and Grout

Methocel MC, 4000 cps., or Methocel 65HG, 4000 cps., are generally used in this application at concentrations from 0.25 to 2.25 per cent, based on the weight of Portland cement in the slurry. With higher viscosity materials, lower concentrations are required.

Building Products

In related building products such as joint cement, patching plaster, latex cements and others, Methocel products are used to give increased "open time," improved workability and when required, added viscosity. The thermal gelation properties of solutions of Methocel can be used to advantage to prevent sagging or dimensional instability problems encountered when compositions are extruded or formed into specific shapes.

NOTICE

The information in this bulletin is presented in good faith, but no warranty is given nor is freedom from any patent owned by The Dow Chemical Company or by others to be inferred.

Defendant's Memorandum of Contentions of Law and Fact—Part III, Pages 15-18

III. Exhibits Expected to be Offered.

A. To Invalidate Patent 2,934,932.

1. On the basis of prior publications.

   a. U. S. Patent 2,700,615 (1955) "Plaster Composition"

   b. U. S. Patent 2,600,018 (1952) "Portland Cement Base Points"

   c. U. S. Patent 2,583,657 (1952) "Low Water-Loss Cement and Process of Making"

   d. Publication "Genuine Clay Tile" Copyrighted 1952 by Don Graf sold by Tile Council of America

   e. British Patent 714,252 (1954) "Improvements in or Relating to Cementitious Compositions"

2. On the basis of prior use and sale #1.

   a. The deposition of Mr. L. E. White taken in this case, along with all exhibits therein.

   b. The deposition of Mr. C. E. Kaiser taken in this case, along with all exhibits therein.

3. On the basis of prior use and sale #2.

   a. Invoice from Gehling Printing and Lithography of August, 1957, for printing on thin set materials.

b. Invoice copies from Braun Chemical Company showing purchase of "Methocel HG" in September, 1956.

c. Mix records of defendant to Support dates of mixing dry mixes.

d. Defendant invoice to Dr. I. V. Fitzgerald dated September 24, 1957.

e. Master Tilers documents of an early public use of.

4. On the basis of the patent prosecution record.

a. The file wrapper of United States Patent 2,934,932 along with all references cited.

5. On the basis of misleading statements to the Patent Office.

a. Records of tests with mortar containing sand and mortar containing no sand.

B. Publications Illustrative of the Prior Art Relative Patent 2,934,932.

a. British Patent 715,032 (1954)—"Method and Composition for The Formation of Concrete Masses."

b. United States Patent 2,427,683

United States Patent 2,423,971

United States Patent 2,580,565

United States Patent 2,598,675

United States Patent 2,614,634

United States Patent 2,629,667

United States Patent 2,655,004

United States Patent 2,662,064

United States Patent 2,672,937

United States Patent 2,673,810

United States Patent 2,699,401

c. Pages 177-178 of "Modern Plastics Magazine"—October, 1951.

d. Dow Chemical Publication entitled "Methocel News"—published 1953.

e. Pages 97, 98 and 99 of Swedish Magazine BYGG-MASTAREN, Volume 33B, 1954 and translation.

f. "TILE TIPS AND TOPICS" Published by the Tile Council of America, issues of February, 1953, July, 1954 and June, 1955.

C. To Invalidate Patent 2,990,382.

1. On the basis of Prior Publications.

a. United States Patent 2,800,463 (1957) "Polyvinyl Acetate Powder and Process of Making Same."

Appendix

b. British Patent 714,252 (1954)—"Improvements in or relating to Cementitious Compositions" (Mortar with methyl cellulose and polyvinyl acetate).

c. United States Patent 2,733,995 (1956) "Polyvinyl Acetate Cement Compositions."

2. On the basis of prior use and sale.

a. Invoice #801—426 showing purchase by Cala-Tile Co. of Vinac RD powder from Braun Corporation.

b. Invoice #830,241 showing purchase by Cala-Tile Co. of Polyvinyl Acetate Powder-Vinac RD from Braun Corporation.

c. Correspondence from Air Reduction Chemical and Carbide Company to establish that Vinac RD powder sold in August and September was spray dried polyvinyl acetate.

d. Invoice copies from August and September of Ceramic Tilers Supply showing sales of dry mixes during those months.

3. On the basis of the patent prosecution record.

a. The File Wrapper of United States Patent 2,990,382.

D. Publications Illustrative of the Prior Art Relative Patent 2,990,382.

a. British Patent 743,952 (1956) "Improvements in or Relating To Coating Composition Containing Synthetic Resin".

E. To Establish No Infringement.

a. Technical Analysis by Dow Chemical Co. of their product "Methocel HG".

Nilsson & Robbins
By Byard G. Nilsson
Attorney for Defendant

Certificate

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

James E. Biava

No. 21160

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Ceramic Tilers Supply, Inc., a corporation,

Appellant,

vs.

Tile Council of America, Inc., a corporation,

Appellee.

APPELLANT'S REPLY BRIEF.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

No. 21160

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Ceramic Tilers Supply, Inc., a corporation,

Appellant,

vs.

Tile Council of America, Inc., a corporation,

Appellee.

APPELLANT'S REPLY BRIEF.

I.

Preliminary Statement.

This brief was necessary to refute several significant erroneous statements in Appellee's Brief. As in the Opening Brief, Appellant (defendant below) is referred to as Tilers Supply and Appellee is called the Council.

The following corrections are in order in the briefs on file.

In Appellant's Opening Brief:

Page 27, line 11, change "recitations of chalk and" to—certain claims reciting—.

In Appellee's Brief:

Page 1, line 3 of the Statement of the Case, omit claim "4" from those of the '382 patent. (The Judgment [R. 164] does not list claim 4 of the '382 patent as being held valid and infringed.)

II.

Spillman Invalidates the Patents Under 35 U.S.C. §102.

The Council acknowledges that Spillman's plaster meets even a tabular comparison with the patented mixes (Appellee's Brief, p. 2). The Council's answer to this total anticipation is the doctrine of commercial success (which is improper here) and the assertion of several erroneous statements summarily considered below. The Council also emphasizes conventional techniques as prior art; however, it is well established that a patentee is charged with knowledge of all the prior art, *Walker v. General Motors Corp.* (9th Cir. 1966), 362 F. 2d 56, 149 U.S.P.Q. 472.

A. The Erroneous Assertion That the Patents Are Limited to Tile-Setting Mortars.

Attempting to contend that Spillman's "plaster" differs from the patented mortars, the Council urges a difference in the intended use.* In fact, the claims of both the patents specify the combinations simply as "mortar" ('932 claims 1, 2, 3, 4, 5, 6 and 7; and '382 claims 1, 2, 3, 4, 5 and 6). The '932 patent then specifically defines the patented mortar combinations as general-purpose mortars, for plastering, stuccoing and laying masonry or tile ('932, column 1, lines 1-4).

As "mortar" is defined by the patent to include plaster, unquestionably Spillman's plaster is a mortar

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*The Council's claims to originality and innovation in the field of tile setting are not supported. In fact, the use of inorganic bonding coats to thin-set dry tile was described in the Council's own 1952 publication [Ex. Y]. Portions of Exhibit Y are reproduced in an Appendix for convenient reference. It is also noteworthy that the Council's initial witness described using a

within the patent claims.** A patent is granted upon a combination of ingredients, not upon the intended employment of the combination. *Celite Corp. v. Dicalite Corp.*, 96 F. 2d 242, 37 U.S.P.Q. 383 (9th Cir. 1938).

B. The Erroneous Assertion That Spillman Was Not Noticed or Argued.

The Council states that Spillman is not properly asserted:

> ". . . defendant never having given the written notice thereof required by 35 U.S.C. §282." (Appellee's Brief, p. 5).
>
> "Nor did defendant ever ask the trier of fact for leave to adduce that reference as evidence of invalidity of the '932 invention." (Appellee's Brief, p. 18).

Although Tilers Supply's major emphasis was on prior use and sale of the patented mortars to invalidate the patents in the court below, such defense was supported by several prior-art references to establish total lack of novelty. Among them, the Spillman patent was noticed, pleaded and argued. The Pre-Trial Conference Order [R. 88] is conclusive of the required notice and states:

> "C. To be offered by Defendant:
>
> Exhibit J. British 743,952."

---

thin-set mortar called Serp-O-Fix prior to 1954 [Tr. 33] a time long before the Council's entry into the field.

**Spillman describes his plaster as being usable in a variety of thicknesses, on a variety of materials (including wood) to provide a flexible shockproof covering [Ex. J, p. 2, lines 11-22]. These objectives and results are identical to those of the patents in suit.

The Order also includes a stated issue of law:

> "2. Does U. S. Patent 2,934,932 define patentable subject matter in view of Exhibit patents and publications prior to one year before the effective filing date?"

The Order was filed in 1963, *over one year before* trial. These quoted statements appeared in the Order in response to Defendant's Trial Memorandum served on the Council, which gave full notice of British patent 743,952, Spillman, Ex. J.

During trial, Tilers Supply produced testimony illustrated by Exhibit BM, to explain the anticipation of the '932 patent by Spillman. A portion of the testimony was as follows:

> "* * * Equating that to 100 percent gives the percentage by weight shown in the second column of numerals taught or indicated by this formulation of *Spillman, British. This falls within '932,* . . . ." [Tr. 876] (emphasis added).

The record thus establishes that: (1) the Council was given written notice of Spillman as anticipatory of the '932 patent *over one year before the trial,* and (2) Tilers Supply introduced testimony applying Spillman to the '932 patent. As no objection was sounded by the Council prior to its appeal brief, it is the Council that now raises a fresh issue on appeal.

C. The Erroneous Assertion That Spillman Discloses a Type of Methylcellulose Other Than the "10 to 7000 Centipoise Viscosity Grade."

This assertion was made to fabricate a basis for contending that the methylcellulose ingredient in Spillman's plaster is different from that specified by the

patents. The Council even attempts to establish that the methylcellulose used by Spillman would not dissolve in water. The argument is truly tortuous and is fully nullified by the fact that Spillman specifically identifies his methylcellulose as being dissolved in water, stating, an *aqueous solution* of methylcellulose [Ex. J, p. 1, line 85].

Spillman's identification of methylcellulose was full and complete. As a matter of public record, the only methylcellulose readily available in the United States was made by the Dow Chemical Company, and sold under the trademark Methocel. A Dow Chemical publication [Ex. AL] which is an Exhibit to the Gremminger deposition in evidence [Ex. AD] was in use in the 1950's and conclusively establishes the grades that were then available.

> "Nine viscosity types of Methocel are available—offering you a range greater than that of any other gum, natural or synthetic! This selection ranges from the lowest, 10 centipoise, through seven intermediate types of 15, 25, 50, 100, 400, 1500 and 4000, to the highest at 7000 centipoise. These ratings are based on the average viscosity of a 2 per cent aqueous solution at 20°C. as shown by Figure 1." [Dep. Ex. AL of Ex. AD].

During the period of concern, the only grades of water-soluble methylcellulose readily available in the United States were *all* of 10 to 7000 centipoise viscosity grade. Therefore, anyone mixing Spillman's plaster would be bound to use a grade of methylcellulose specified by the patent claims. Spillman's disclosure is clear, complete, concise and anticipatory.

D. The Erroneous Assertion That Spillman's Plaster Contains Chalk but Not Limestone.

This false assertion is made as a basis for excluding chalk from the combination of ingredients specified in the '932 patent claims, one of these ingredients being sand and/or powdered limestone.*

The argued distinction between chalk and limestone is not only completely unsupported in the evidence, but testimony was to the contrary. The Council acknowledges its expert stated that both limestone and chalk are essentially calcium carbonate (Appellee's Brief, p. 54). The Council has given no evidence to remove chalk from the classification as a form of limestone, and the evidence of the relationship of these terms is unchallenged.

> "The Court: And what is chalk?
>
> The Witness: It is a form of limestone, your Honor" [Tr. 854].

The true signification of the words "chalk" and "limestone" is established beyond any question of a doubt, and no evidence of any unusual meaning has been introduced. Therefore, the term is used in its

---

*The Council's argument based on a technicality, imparting special significance to the words "consisting essentially of" is raised by the Council for the first time in the brief. The argument is applicable, not to distinguish the Spillman patent, but rather to distinguish the accused products, all of which contain extraneous ingredients. Particularly significant is the fact that most of Tilers Supply products contain calcium chloride [Ex. 15-1 to 15-9] which, in the prosecution of the patent application, was the ingredient responsible for the words "consisting essentially of" in the claims [Ex. AB, p. 31]. However, the more authoritative view is that, although the term "consisting" is limiting, its modification by the term "essentially" opens the claims to the inclusion of other ingredients characteristic of the combination. *In re Janakirama-Rao* (CCPA-1963), 317 F. 2d 951, 50 CCPA 1312, 137 U.S.P.Q. 893.

ordinary sense. *Chemical Construction Corporation v. Jones & Laughlin Steel Corp.* (3rd Cir. 1962), 311 F. 2d 367, 136 U.S.P.Q. 150.

Chalk: "A soft, white, powdery limestone consisting chiefly of fossil shells of foraminifera." (*The Random House Dictionary of the English Language,* 1966).

Chalk: "A soft, friable, limestone of marine origin, earthy in texture and white, gray or buff in color, found widely distributed in Europe and America, chiefly in the Cretaceous system, and composed for the most part of the minute shells of the Foraminifera." (*Webster's Third New International Dictionary,* 1961).

Chalk: "A white, or grayish loosely coherent kind of limestone rock, composed almost entirely of the calcareous remains of minute marine organisms and fragments of shells." (*Thorpe's Dictionary of Applied Chemistry,* Volume II, 1938).

The Council's struggle to move chalk out of the limestone classification borders on the fraud urged to the Patent Office in distinguishing a prior mix because it contained "chalk", then distinguishing the patented mix because it contained "limestone."

Spillman's plaster contains pulverized chalk. Chalk is a form of limestone. Spillman's plaster contains powdered limestone as specified in the '932 claims. If developed later, Spillman's mortar would infringe the '932 patent. Therefore, as Spillman is earlier, the '932 patent is invalid. *Sperry Rand Corp. v. Knapp Monarch Co.* (3rd Cir. 1962), 307 F. 2d 344, 134 U.S.P.Q. 433.

E. The Erroneous Assertion That Defendant Contends There Is No Difference Between Wet and Dry Polyvinyl Acetate.

Tilers Supply certainly does not contend the contradiction that "wet" is "dry." Well prior to the '382 patent, wet polyvinyl acetate (Wilhold glue) had been used in cementitious combinations along with methylcellulose, as documented by Spillman and established in testimony [Tr. 1218]. The combination of the ingredients in mortars was known and used. Upon the development (by others) of a dry form of polyvinyl acetate, no invention was required to substitute the newly-available dry form of the material in mortars to do exactly what the wet had always done.

Such a combination was fully anticipated upon the invention of the process for making the dry ingredient, as stated in the patent for that process:

> ". . . a dry, powder form from which the original emulsion could be substantially fully reconstituted upon simple mixing with the proper proportion of water, . . ." [Ex. G, column 3, lines 7-9].

It is noteworthy that Appellee's Brief (p. 31) relies heavily on what is stated as "synergism" to evidence invention. As defined by the Council's witness, synergism is an improvement by combination [Tr. 229]. The combination was known before the '382 patent as evidenced by Spillman. It was merely a matter of using a more convenient form of one of the ingredients. Furthermore, in fact with respect to the two asserted features of the invention, the patentee would only say:

> "you might say there is synergism"

and

> "there is no particular synergism." [Tr. 232].

Therefore, synergism, in the sense urged by the Council, is questionable and more important, the combination was simply old. The patented mortar mix clearly lacks the new or different functional relationship over the prior art required to sustain a combination patent. *Kwikset Locks, Inc. v. Hillgren* (9th Cir. 1954), 210 F. 2d 483, 100 U.S.P.Q. 289.

III.

The Council's Fraud on the Patent Office Was Pleaded and Is Established.

The answer to the Council's technical contention that the allegation of fraud is untimely is provided by the Pre-Trial Conference Order [R. 88] which sets forth as a specific issue of law:

> "6. Was United States Patent 2,934,932 granted on the basis of false and misleading statements made to the United States Patent Office to thereby render the patent invalid?"

The Council's answer to this fraud, if true, renders the fraud even *more culpable*. The Council now asserts that certain forms of limestone, as chalk are unsuitable in the '932 combination. If that is true, the Council filed fraudulent affidavits, to obtain patent coverage that should not have been granted.

If (as the Council now contends) certain forms of limestone, as chalk, are unsuitable in the '932 combination, it undeniably follows that the Council selected *suitable* forms of limestone for the tests submitted to the Examiner in Dr. Wagner's affidavits. Yet, those affidavits and the accompanying remarks, sought claims that broadly recited "powdered limestone", en-

compassing the *entire classification* of the limestone mineral.

If certain forms of limestone, as chalk, are unsatisfactory in the patented combination, they were deliberately concealed in Dr. Wagner's affidavits [Ex. AB, p. 37] to obtain broad claims encompassing mortars containing *any form* of powdered limestone. That fraud was the basis for claiming too much from the Patent Office, in violation of 35 U.S.C. §112.

> "The specification shall conclude with one or more claims particularly pointing out and distinctly claiming the subject matter . . ."

For convenience the two conflicting statements of fact are quoted below:

> "The Examiner has also cited . . . Heijmer patents as disclosing 'use of methyl cellulose in the range claimed by applicant contained in a cementitious composition.' The methyl cellulose is indeed disclosed in these patents, but the claimed combination is lacking. * * * Heijmer's plasters must contain chalk and may also contain pumice." [Ex. AB, p. 25].

later:

> ". . . the inclusion of sand or limestone in the compositions of the present case result not only in composition differences but a distinct alteration in the characteristics of the compositions after setting." [Ex. AB, p. 34]
>
> "The claims remaining in the present application all recite sand or limestone, the ingredients necessary for mortar. It is, therefore, respectfully suggested that the claims in the present case are clearly distinguishable over those in the issued patent. . . ." [Ex. AB, p. 35].

Preliminarily, note that the first passage admits the identity of the methylcellulose disclosed in the Heijmer patent to that of the '932 patent. The only distinction urged is that Heijmer incorporates chalk as an ingredient. At that stage of the prosecution, the issue was pinpointed.

Whether the Council simply made the time-separated statements to accomplish two distinctions, or as now asserted, believed in a distinction between "chalk" and "limestone" in the mix, there was fraud. That fraud on the Patent Office resulted in the patent grant.

IV.

Kaveler Blocks the Equivalency in Law, of Methylcellulose and Hydroxymethylcellulose.

Kaveler states that his mortar is useful for grouting in general [Ex. P, column 2, lines 7-9]. Grouting is one of the stated uses of the patented mortars. Therefore, there is no true basis for arguing Kaveler is unrelated to the patented mortars.

The Council's protestations regarding viscosity, solubility and degree of substitution are unsupported and meaningless. Dr. Stone's undisputed testimony conclusively established that Kaveler describes Dow Methocel HG (hydroxypropyl methylcellulose) as purchased and used by Tilers Supply [Tr. 793]. Arguments and distinctions aimed at Kaveler's examples other than hydroxypropyl methylcellulose are meaningless.

The reference in the Council's brief to testimony at pages 1226-1227 appears to fail completely to support the argument for which it is cited on page 50 of Appellee's Brief.

V.

The Allegation of Copying Remains Totally Unfounded.

The unsupported charge by the Council that Tilers Supply copied remains pure fiction. In an attempt to support its accusation, the Council now urges the fact that it sent a formulation into Southern California before Tilers Supply entered the market.

The inconclusive nature of that fact does not merit argument. Many considerations completely refute the copying charge.

1. The Council has not presented any formula for comparison with Tilers Supply products. The Council has 6 or 7 patents relating to mortars [Tr. 48] and the formulations sent to California may well have related to any of those patents or to mortar mixes containing no sand or limestone as were still being asserted to the Patent Office as fully representative of the Council's "development" when Tilers Supply introduced its product.

2. The Council has still not established any access to any of their formulations by Tilers Supply.

3. The Council was not the first to market this mortar mix and in fact the circumstances which enabled successful marketing were recognized almost simultaneously by many [Tr. 1215]. Although the Council contends its mortar was introduced in 1957 (Appellee's Brief, p. 51) the referenced page of the record [Tr. 16] certainly does not establish that contention.

VI.

Charges of Misconduct Against Tilers Supply Are Unsupported, Unfair and Misleading.

The Council has charged misconduct with respect to four Tilers Supply witnesses. The charge against Mr. Knesel is that he sought to prove ethyl cellulose would dissolve in water and thereby establish the Heijmer patent. First, the solubility of ethyl cellulose in water is totally immaterial to this suit. Heijmer discloses methyl cellulose which is the ingredient of the patents. The disclosure of ethyl cellulose in Heijmer as an alternative ingredient although totally immaterial was recognized as operative by Dr. Stone [Tr. 796]. The immateriality of this point is further established by the fact that it was not even considered an issue of fact in the Pre-Trial Memorandum.

Second, Mr. Knesel was not testifying to establish any reference, as the Council contends but on the contrary was merely explaining his background experience with various gums and demonstrating their function [Tr. 492].

In more than a full day of testimony by Mr. Knesel, the single basis for a charge of misconduct is that he contracted the word "hydroxy ethyl cellulose" to "ethyl cellulose." The contraction was: without deceptive intent, of no effect and clearly logical. The Council's charge of misconduct on this point is unreasonable and unjust.

The Council's charge of misconduct against Mr. Lavenberg is pure fiction. Mr. Lavenberg gave his opinion of a tile failure at the Water & Power Building in which the Council's mortar was used. He also signed

a committee report analyzing the failure. Repeated and careful study (even by the witness) has revealed absolutely no inconsistency in Mr. Lavenberg's testimony and/or his part in the report. The Council's incomprehensible charge of misconduct by this witness is extremely unfair to Tilers Supply and to the witness.

Based on impressions given by the witness the Council challenged the testimony of Mr. Matheney and successfully eliminated his testimony. Mr. Matheney's testimony was given as an independent technical expert witness from a recognized laboratory employed by Tilers Supply and was eliminated because:

1. He could not precisely recall the formulas on which tests were performed.
2. He was not precise in explaining that the formulations tested were in part determined cooperatively with Mr. Knesel, then independently confirmed by the witness [Tr. 953, 967 and 968].

Mr. Matheney, as a chemist for a testing laboratory, was employed to perform technical tests and analysis outside the control of Tilers Supply. Were the situation otherwise, such testimony would be meaningless. The failure of this witness to refresh his recollection of circumstances and tests occurring more than one year prior to his court appearance cannot be counted as misconduct by Tilers Supply [Tr. 968].

The testimony of Mr. Shirm was his own and is not linked to Tilers Supply in any manner. His change of testimony was completely unexpected by Tilers Supply. However, as such it certainly does not support any charge of misconduct by Tilers Supply.

VII.
Conclusion.

The only point of difference in substance between either of the patents and Spillman lies in the '382 combination using dry glue (polyvinyl acetate) rather than wet. The Council was fully aware of this prior to filing the suit. In view of the assertion of the patents under these circumstances, coupled with the procurement of the '932 patent by fraud, reversal is respectfully requested with appropriate instructions for compensatory proceedings for Tilers Supply under *Walker Process Equipment, Inc. v. Food Machinery and Chemical Corporation,* 382 U.S. 172; 86 S. Ct. 347 (1965).

Respectfully submitted,

Nilsson, Robbins & Anderson,
By Byard G. Nilsson,
Attorneys for Appellant.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

Byard G. Nilsson

APPENDIX.

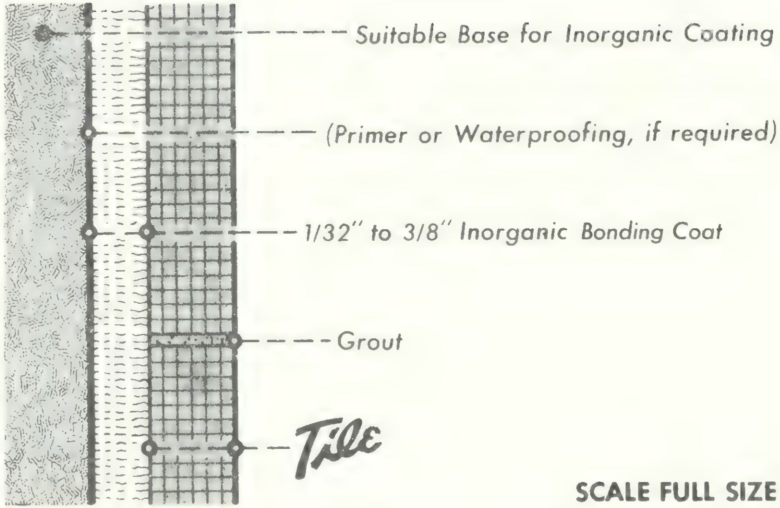

*Chart from page 6 of Exhibit Y.

2. INORGANIC BONDING COATS — Trade-marked products consisting basically of an inorganic cementitious matrix in a water, turpentine, or other relatively odorless vehicle. Usually applied 1/8″ in thickness, but one or more thicker coats may be used for leveling. A wide variety of old or new surfaces (including asphaltic) are suitable if dry, clean, firm, and reasonably true. Some inorganic coatings are not recommended for use over glossy paint, marble, terrazzo, slate, old Tile, or hardboard. Manufacturers of other types do not disqualify such bases. Manufacturers variously describe their respective products as flexible or brittle, non-staining, water-resistant, non-toxic, non-combustible, or combustible before set only.

H1. INORGANIC BONDING COATS

— Where this type of thin setting material is to be used it must be suitable for the installation of Tilework under the conditions described in these Contract Documents. Install where designated (. . . to a thickness . . .) on suitable surfaces and complete the Tilework installation with other necessary products in strict accordance with the directions of the setting bed material manufacturer as shown on the container labels, described in his current printed literature, or in his specially written instruction for this project.

The different materials falling into this category of setting beds may require that the Tile during placing be wet, damp, dry, or may allow latitude in the wetness or dryness. Other mandatory cautions to be observed are fully provided for in the suggested paragraph above.

*Paragraph from page 17 of Exhibit Y.

APPENDIX.

Table of Exhibits.

Exhibit	Identified	Offered	Received
G	475	475	475
J	475	475	475
P	475	475	475
Y	479	479	479
AB	485	485	485
AD	903	904	904
AL	Deposition Exhibit of Exhibit AD		
BM	875	881	881
15	96	97	97

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PETITION FOR REHEARING.

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PETITION FOR REHEARING.

Appellant, Ceramic Tilers Supply, Inc., hereby petitions for a rehearing to reconsider the judgment entered in this action on May 22, 1967, on the following grounds.

1. Limestone Is Generic to Chalk; Therefore, by Definition, Functional Difference Is Not Possible.

The principal question in the present posture of the case is whether a patented recipe is anticipated by a prior recipe in which "pulverized chalk whiting" is specified as an ingredient rather than the claim-specified: "powdered limestone" *(not granular).* The prior formula is distinguished, essentially only by this difference, and the Court found an apparent functional difference between the "limestone" and "chalk ingredients.

Testimony of Appellee's expert, Dr. Lacy, is directly to the contrary:

> "Q. Now as I understand it, chalk is also a form of calcium carbonate or limestone, is that correct? A. Yes. It is a form of calcium carbonate.
>
> Q. In reading the claims and in considering their description of various ingredients here, which we have also considered in other instances, I understand that you certainly considered somewhat as equivalent *calcium carbonate* and *limestone* and *sand* wherever those ingredients were specified, is that true? A. *Functionally I think they would be all the same.*" [RT 289:6-15] (emphasis added.)

It is further respectfully submitted that the applicable law of this Court, the trial record of the case, and facts of judicial notice conclusively and irrefutably establish that *"pulverized chalk whiting"* is one form or species of *"powdered limestone."* The word "limestone" includes "chalk" by definition, therefore functional differences between the two cannot exist.

The following premises, each above reproach, here presented without argument, establish the asserted patent to be invalid.

ISSUE:

(a) The basis of distinguishing the patent from the prior art (Opinion P3) is that the ingredient recited in the patent's claims as *"powdered limestone"* differs from *"pulverized chalk whiting"* as recited in the prior recipe. (See U. S. Patent 2,934,932 and Ex. J, Spillman.)

LAW:

(b) The words *"powdered limestone"* are not explained in the patent; therefore, they must be given their ordinary meaning (see *U. S. Patent*

2,934,932; Chemical Construction Corporation v. Jones & Laughlin Steel Corp. (3rd Cir. 1962), 311 F. 2d 367, 136 U.S.P.Q. 150. *Universal Oil Products Co. v. Globe Oil & Refining Company,* 137 F. 2d 3, 58 U.S.P.Q. 504 (7th Cir. 1943) Affd. 322 U.S. 471, 61 U.S.P.Q. 382).

FACT:

(c) By ordinary meaning, the words *"powdered limestone"* concisely and clearly define *any* of a class of calcium carbonate minerals reduced to a finely-divided state. That definition clearly includes *"pulverized chalk whiting,"* by universal definition.

LIMESTONE:

> "sedimentary rock wholly or in large part composed of calcium carbonate. It is ordinarily white but may be colored by impurities, iron oxide making it brown, yellow or red and carbon making it blue, black or grey. The texture varies from coarse to fine. . . . Among the important varieties of limestone are, MARL, CHALK, OOLITE, TRAVERTINE, DOLOMITE, and MARBLE." *The Columbia Encyclopedia* (1959).
>
> (See other authorities set out in the appendix at length.)

LAW:

(d) As the patent broadly claims all those pulverized rocks defined as "powdered limestone," it may not be limited at this time to exclude one specific rock in the group. Excessively-broad claims cannot be saved by distorting the meaning of their words. *Beatty Scaffold Company v. Up-Right, Inc.* (9th Cir. 1962), 306 F. 2d 626, 134 U.S.P.Q. 379; also *Del Francia v. Stanthony Corp.* (9th Cir. 1960), 125 U.S.P.Q. 382.

LAW:

(e) As the broad term "powdered limestone" defines a group of pulverized rocks that include "pulverized chalk whiting", the reference formula would unquestionably *infringe the claims of the patent.* That which would infringe if later, invalidates if earlier. That is, the prior formula (essentially identical to the patented formula but for the recitation of *chalk* rather than *limestone*) would clearly fall within the scope of the patent claims. As an unavoidable consequence, the patent is *invalid. Becker v. Webcor, Inc.* (7th Cir. 1961), 129 U.S.P.Q. 111; *Chemical Construction Corporation v. Jones & Laughlin Steel Corp.* (3rd Cir. 1962), 311 F. 2d 367, 136 U.S.-P.Q. 150; *In re Slater,* 276 F. 2d 408, 125 U.S.P.Q. 345 (C.C.P.A., 1960); also *Smith-Blair, Inc. v. Dresser Industries, Inc.* (D.C. N. Calif.), 131 U.S.P.Q. 305.

The logic set forth above is supported in the record and does not conflict with actual testimony taken during trial, nor, is there substantial legal authority to the contrary. (See sections 2 and 3 of the Appendix relative to finely-divided fibrous material and testimony of appellant's president.)

2. A Determination That the Cellulose Gums Are Equivalent for Infringement Purposes, Necessitates Their Equivalence for Validity Purposes.

Succinctly, if the cellulose gums in the recipes are equivalent for determining infringement, they are also equivalent *for determining validity. Air Devices, Inc. v. Air Factors, Inc. et al.* (9th Cir. 1954), 210 F. 2d 481, 100 U.S.P.Q. 296; *Moon v. Cabot Shops, Inc., et al.* (9th Cir. 1959), 270 F. 2d 539, 123 U.S.P.Q. 60;

Nelson v. Batson (9th Cir. 1963), 322 F. 2d 132, 138 U.S.P.Q. 522. As an unavoidable consequence, of finding equivalence, for infringement purposes, United States Patent 2,934,932 is invalid on the basis of the recipe disclosed in the Kaveler patent, Ex. P. A recognized expert in the field of cellulostics, Dr. Stone, testified conclusively and without challenge, that the cellulose gum employed in the accused mortar mixes is identical to that described in the prior-art reference Ex. P. [Tr. 793].

Dated: June 20, 1967.

Byard G. Nilsson,
Attorney for Ceramic Tilers Supply, Inc.

Undersigned Counsel certifies that this petition is not interposed for delay and that in his judgment it is well founded.

BYARD G. NILSSON

APPENDIX.

1. The Ordinary Meaning of the Words, "POWDERED LIMESTONE."

POWDERED: "reduced to a powder; PULVERIZED." *Webster's Third New International Dictionary* (1961).

POWDER: "to become pulverized" *The Random House Dictionary of the English Language* (1966).

LIMESTONE: "any stone consisting wholly or mainly of calcium carbonate." *The Random House Dictionary of the English Language* (1966).

LIMESTONE: "a rock that is chiefly formed by accumulation of organic remains . . . that consists mainly of calcium carbonate. . . ." *Webster's Third New International Dictionary* (1961).

"LIMESTONE, is a common and widely distributed sedimentary rock consisting essentially of calcium carbonate, $CaCo_3$, but varying greatly in composition, color and texture. Most limestones are of organic origin and represent the calcareous remains of animal and plant organisms usually inhabiting salt water. . . .

. . . "CHALK, a type of limestone, is composed of the microscopic skeletons of foraminifera." *The Encyclopedia Americana,* Vol. 17 (1967).

WHITING: "pure-white chalk (calcium carbonate) which has been ground and washed. . . ." The Random House Dictionary of the English Language (1966).

ROCKS—"Any solid mineral substance, of whatever character, naturally deposited, forming part of the surface or crust of the earth; From a geological point of view granite, *chalk,* gravel, sand, and clay are all rocks."

The Universal Dictionary of the English Language, Published by George Routledge & Sons, Ltd. 1932 ED.

LIMESTONE—All limestones from the softest *chalks* to the hardest marbles consisting essentially of *carbonate of lime.*

New English Dictionary of Historical Principals, Oxford University Press, Oxford, England.

2. The Trial Record Does Not Establish Functional Differences Between Chalk and Limestone in the Patented Recipe.

The ingredient "chalk whiting" by common definition is a type of limestone. In addition to serving as an aggregate ingredient, it may be used to "whiten" the recipe mix to which it is added. Because it is select and prepared, it is normally more expensive. Nevertheless, it is undisputably *limestone.* It is sometimes practical to employ both chalk whiting and a cheaper pulverized limestone in a mortar, as for reasons of economy. Yet, in function as an aggregate, both are clearly *"limestone" as expressly specified* in the patent claims. Thus, the testimony of appellant's president [RT 638:6-24 and RT 642:18], appellee's expert [RT 288] and appellant's expert [RT 854] all support the ordinary meaning of the words in question. Chalk is a form of limestone! Functionally, the specific is identical to the generic.

3. The Accused Mortars Include Divided Fibrous Materials.

To the point that the Spillman patent [Ex. J] states:

> "If desired, further finely divided fibrous materials, such as saw dust, may be added to the filler" [Ex. J, p. 2]

the asserted patent states:

> "Certain other ingredients may be used in the mortars for particular purposes, these being generally used in minor amounts."
>
> (Patent 2,934,932, column 5, line 71)

In fact, one of the accused mixes (now adjudged to infringe) includes another ingredient. Furthermore, that ingredient is a *"finely divided fibrous material"* just as specified in Spillman [Ex. J]. The ingredient is asbestos. [Pre-trial Conference Order R. 88]

No. 21,165

IN THE

United States Court of Appeals
For the Ninth Circuit

American Telephone and Telegraph Company, Security Savings and Loan Association and Victoria Savings and Loan Association,

Appellants,

vs.

Federal Deposit Insurance Corporation, etc., et al.,

Appellees.

OPENING BRIEF OF APPELLANT AMERICAN TELEPHONE AND TELEGRAPH COMPANY

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Table of Contents

Table of Authorities

Cases

Statutes

Court Rules

Regulations

Other Authorities

No. 21,165

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OPENING BRIEF OF APPELLANT AMERICAN TELEPHONE AND TELEGRAPH COMPANY

PRELIMINARY STATEMENT

This case involves the rights of depositors to participate in the distribution of the assets of an insolvent national bank. It raises two questions: (1) whether a depositor is entitled to the return of a deposit which was obtained by fraud; and (2) whether depositors who participated with the bank in wrongful acts should be subordinated to innocent depositors in the distribution of the bank's assets.

STATEMENT OF JURISDICTION

Appellant American Telephone and Telegraph Company, a depositor in the insolvent San Francisco National Bank, brought an action in the United States District Court for the Northern District of California (1) to prevent the Bank's receiver (Federal Deposit Insurance Corporation) from distributing the Bank's assets to depositors who participated with the Bank in wrongful acts, until innocent depositors, including appellant, had been paid in full; and (2) to recover its deposit either by rescission or by the imposition of a constructive trust on the assets of the Bank in favor of appellant (R. 2-12). The district court (Honorable William C. Mathes, Senior United States District Judge) dismissed the action as to all defendants except the receiver on the ground that no Federal question had been stated as to them,[1] and later dismissed the entire action (R. 155-156).

The district court had jurisdiction of the action, with respect to defendant Federal Deposit Insurance Corporation (hereinafter referred to as "FDIC"), under section 1819 of Title 12 of the United States Code (64 Stat. 873, 881) which provides that

> "All suits of a civil nature at common law or in equity to which the [Federal Deposit Insurance] Corporation shall be a party shall be deemed to arise under the laws of the United States."

[1]The dismissal of defendants other than the receiver was embodied in two orders; the first, on the court's own motion and without notice or hearing (R. 93-94), and the second, denying a motion by appellant to vacate the first order (R. 157-158).

The district court acknowledged its jurisdiction over FDIC but not over the other defendants. It is the position of appellant that the district court had jurisdiction over those defendants pursuant to section 1331 of Title 28 of the United States Code because "the matter in controversy exceeds the sum or value of $10,000, exclusive of interest and costs, and arises under the * * * laws * * * of the United States." The jurisdiction of the district court over those defendants is more fully discussed at pages 13-16 of this brief.

This Court has jurisdiction of this appeal pursuant to section 1291 of Title 28 of the United States Code.

THE FACTS

Since the action was dismissed on the pleadings, the matters alleged in the complaint must be taken as true (*Williford v. People of California* (9 Cir. 1965) 352 F.2d 474, 475).

On December 28, 1964, appellant renewed a deposit of $500,000 with San Francisco National Bank and received a certificate of deposit for that sum payable, with interest, on a date certain (R. 5; see also R. 78). Eighteen banking days later, on January 22, 1965, the Bank was closed by the Comptroller of the Currency, and FDIC was appointed its receiver (R. 6; see also R. 79).

The sole compensation that appellant received for its deposit was the promise of the Bank to pay interest at a legal rate. Other holders of certificates of deposit (who are defendants in this action) directly or indirectly re-

ceived, in addition to interest at the legal rate, illegal bonuses or bounties for their deposits (R. 4-5).

FDIC in its answer "admit[s] that some of the other defendants * * * received bounties directly or indirectly from the bank as alleged" (R. 78). A report of the United States Senate Committee on Governmental Operations, of which the court below had notice, states that "abuses associated with certificates of deposit are principal factors in the chain of events that led to recent bank failures," and gives as an example "San Francisco National Bank, which paid 7 percent for certain large amounts of funds obtained by certificates of deposit" (Interim Report of Committee on Governmental Operations (U.S. Senate, 89th Cong., 2d Sess.), p. 6, see also pp. 8 and 31).[2]

Also, when appellant renewed its deposit, the Bank's officials concealed from appellant (1) the fact that the Bank was paying bounties and engaging in other illegal activities, and (2) the fact that the Bank was then insolvent or in imminent danger of becoming insolvent (R. 5-6). Had appellant known the true financial condition of the Bank, or of the payment of bounties, or of the other illegal activities, it would not have renewed its deposit (R. 6).

Appellant rescinded its deposit and demanded the return of its $500,000 (R. 7; see also R. 80). Except to the extent that FDIC paid appellant $10,000 insurance pro-

[2]The FDIC, relying on that report, informed the court that this conduct "contributed to the failure of San Francisco National Bank" (Closing Brief of FDIC in support of motion to dismiss in *A.M.R., Inc., et al. v. Federal Reserve Bank of San Francisco, et al.* (Civil Action No. 44387, p. 4; quoted R. 142).

ceeds for that portion of the deposit protected by Federal Deposit Insurance, FDIC refused to return appellant's deposit (R. 7; see also R. 80-81). It took the position that appellant may only share in the assets of the Bank on the same basis as all general creditors (R. 81), including those depositors which FDIC admits received bounties from the Bank (R. 78).

Appellant thereupon brought this action in the district court for the return of its deposit and, in addition, to compel subordination of the claims of the bounty takers to the claims of appellant and the other innocent depositors (R. 1-12). On its own motion and without notice or hearing (R. 93), the court below dismissed the action as to all defendants other than FDIC on the ground that

> "* * * it appears that any claim or cause of action which plaintiff has against the defendants other than Federal Deposit Insurance Corporation is non-federal in character, arises under State law, and may properly be prosecuted in the State courts" (R. 92).

Appellant moved to vacate this order (R. 95-110), but the court denied the motion (R. 157-158).[3] The order also provided that

> "* * * it appearing to the Court that, in addition to the reasons set forth in the Order Dismissing Action as to Certain Defendants and as to Certain Claims, said order was entered without prejudice to the right of the dismissed defendants and cross-defendants, if so advised, to seek intervention pursuant to Fed.R.

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[3]The motion to vacate was also denied without a hearing. It had been set for hearing on April 28, 1966 (R. 95). However, before that date the district court issued an order that this and other motions be deemed submitted on the date set without hearing (R. 487).

> Civ.P. 24 in Civil Action No. 43512, *In the Matter of the Liquidation of the San Francisco National Bank,* now pending in this Court; * * *'' (R. 157).

Meanwhile, FDIC had moved to dismiss the action (R. 126-129). The motion was granted by Judge Mathes,[4] with similar ''leave to plaintiff * * * to present * * * [its] claims by seeking intervention pursuant to Fed.R.Civ.P. 24, in Civil Action No. 43512, *In the Matter of the Liquidation of the San Francisco National Bank,* now pending in this Court'' (R. 155-156).

Appellant filed timely notice of appeal (R. 457). Appellant, observing Judge Mathes' suggestion, also filed a petition to intervene in the liquidation proceeding, then pending before Judge Wollenberg (*In the Matter of the Liquidation of the San Francisco National Bank,* U.S.D.C. No. 43512). Judge Wollenberg denied appellant's petition (R. 151-152 in No. 21258 now pending in this Court), and appellant filed timely notice of appeal from that denial (ibid., at 153).

The cross claimants

Two of the defendants named as bounty takers (Victoria Savings & Loan Assn. and Security Savings & Loan Assn.) denied receiving bounties, and made cross demands against appellant and all other defendants, alleging substantially the same facts as appellant and demanding substantially the same relief (R. 210-234, 196-204). Their cross demands were dismissed on the same grounds and at the same time as appellant's claim (R. 93-94; 155-158),

---

[4]This motion was likewise granted without a hearing. It had been noticed for May 24 (R. 128), but by order of the court was taken under submission without hearing (R. 487).

and they likewise have appealed (R. 159-160, 423-424). Two other defendants (State Savings & Loan Assn. of Stockton and Benj. Franklin Federal Savings & Loan Assn.) did not cross complain but, in their answers, denied taking bounties and prayed for the same affirmative relief as was demanded by appellant (R. 178-188; 325-336).

SPECIFICATION OF ERRORS

The Court below erred

(1) in dismissing appellants' action in so far as appellant seeks a return of its deposit in San Francisco National Bank either by rescission or through the imposition of a constructive trust;

(2) in dismissing the defendants other than FDIC from the action;

(3) in dismissing the action in so far as appellant seeks to establish that depositors who received bounties should not be permitted to share equally with appellant and other depositors who did not participate in any wrongdoing.

ARGUMENT

I. THE COMPLAINT STATES FACTS WHICH ENTITLE APPELLANT TO RESCISSION AND TO A CONSTRUCTIVE TRUST.

Where a deposit is accepted by a national bank under the circumstances described above, courts of equity will allow a rescission or impose a constructive trust on a deposit which augments the assets of the bank and which can be traced into the hands of the receiver.

A. The Bank's fraudulent acceptance of appellant's renewal of deposit is grounds for rescission or imposing a constructive trust.

A bank commits a fraud upon a depositor when it accepts his deposit while insolvent, to the knowledge of its officers.

> "* * * [O]fficers who receive deposits in an insolvent bank are guilty of a fraud, if not a crime * * *. [A]ll the authorities agree that the receipt of a deposit by an insolvent bank is a fraud on the depositor, that title to the deposit does not pass, and that the deposit may be followed so long as it can be identified" (*Federal Reserve Bank v. Idaho Grimm Alfalfa Seed G. Ass'n* (9 Cir. 1925) 8 F.2d 922, 928, certiorari denied (1926) 270 U.S. 646).

Under such circumstances, the depositor is entitled to recover his deposit either by rescission or the imposition of a constructive trust (*St. Louis &c. Railway Co. v. Johnston* (1890) 133 U.S. 566, 576-577; *Carnegie-Illinois Steel Corporation v. Berger* (3 Cir. 1939) 105 F.2d 485, 487, certiorari denied (1939) 308 U.S. 603).

In addition a depositor is entitled to a constructive trust when his deposit is received under circumstances other than insolvency if it was wrong or contrary to law or good conscience for the bank to accept the deposit as a general deposit (*Tucker v. Newcomb* (4 Cir. 1933) 67 F.2d 177, 179).

San Francisco National Bank was known by its officers to be insolvent or in imminent danger of becoming insolvent when appellant renewed its deposit of $500,000 (R. 6). The Bank concealed that fact from appellant (R. 6). It also concealed the fact that it was paying illegal boun-

ties to other depositors, and that its officers were engaged in other illegal activities which imperiled its financial stability (R. 6). The Bank's acceptance of the renewal of appellant's deposit under such circumstances perpetrated a fraud upon appellant (R. 8).

Section 50 of the National Bank Act (Act of June 3, 1864, 13 Stat. 99, 114-115; 12 U.S.C. 194),[5] which provides for ratable distribution of the assets of an insolvent national bank, permits rescission or the imposition of a constructive trust. The depositor is entitled to recover because he has a right to the money deposited, and to the extent he has such right the receiver has none (ibid., see also *Moran v. Judson* (D.C.Cir. 1938) 96 F.2d 551, 554). As the United States Supreme Court has said:

> "The requirement as to ratable dividends, is to make them from what belongs to the bank, and that which at the time of insolvency belongs of right to the debtor does not belong to the bank" (*Scott v. Armstrong* (1892) 146 U.S. 499, 510).

B. The renewal of appellant's deposit augmented the assets of the Bank.

A deposit augments the assets of a bank when the bank obtains the right to use funds to which it otherwise would not be entitled. Transactions analogous to the renewal of a certificate of deposit have been held to be an augmenta-

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[5]This statute provides, in relevant part:

> "From time to time, after full provision has been first made for refunding to the United States any deficiency in redeeming the notes of such association, the comptroller shall make a ratable dividend of the money so paid over to him by such receiver on all such claims as may have been proved to his satisfaction or adjudicated in a court of competent jurisdiction, and, as the proceeds of the assets of such association are paid over to him, shall make further dividends on all claims previously proved or adjudicated; * * *."

tion of assets. In *Federal Reserve Bank v. Idaho Grimm Alfalfa Seed G. Ass'n* (9 Cir. 1925) 8 F.2d 922, 928, certiorari denied (1926) 270 U.S. 646, this Court held that a deposit of checks drawn on another bank augments the assets of the depository bank, despite the fact that the depository bank used the credits for the checks to offset its debts in clearing transactions. Similarly, in *Am. Nat'l Bank v. Miller* (1913) 229 U.S. 517, the Supreme Court held that there was a deposit when a bank, being presented with a check drawn upon it, merely debited the account of the drawer and credited the account of the payee:

> "In the present case it was as though an officer of the Macon Bank [Payee] had presented the check to the Teller of the Nashville Bank [drawee and collecting agent of the Macon Bank] and on receiving the money had paid it back over the counter for deposit to the credit of the Macon Bank" (*Am. Nat'l. Bank v. Miller* (1913) 229 U.S. 517, 520).[6]

Similarly, appellant, by its renewal, merely short cut the formality of a withdrawal and redeposit.

For purposes of finding augmentation, the situation in the instant case must be carefully distinguished from that which would have obtained had there been no fraud by the Bank.

> *Jennings v. U.S.F. & G. Co.* (1935) 294 U.S. 216, 222-223;
>
> *Adams v. Champion* (1935) 294 U.S. 231, 236-238;

[6]Cases can be found which reflect a mechanistic approach to augmentation. See, e.g., *Walsh v. Deitrick* (D.Mass. 1938) 22 F. Supp. 377. However, a just and equitable application of the augmentation rules requires rejection of this approach.

Old Company's Lehigh v. Meeker (1935) 294 U.S. 227, 229;

Hoffman v. Rauch (1937) 300 U.S. 255, 257.

As the Court pointed out in the *Jennings* case, the courts are more inclined to find an augmentation in cases of constructive trusts or trusts ex maleficio (*Jennings v. U.S.F. & G. Co.* (1935) 294 U.S. 222-223).[7]

C. Appellant's deposit may be traced into the assets of the Bank.

The December 28, 1964 deposit may be traced into the assets of the Bank. Since the Bank committed a fraud on appellant, it had no right to commingle the deposit with its other funds, and is presumed to have set apart the $500,000 and maintained that sum as the property of appellant.

National Bank v. Insurance Co. (1881) 104 U.S. 54, 69-70;

Merchants' Nat. Bank v. School Dist. No. 8 (9 Cir. 1899) 94 Fed. 705, 707;

Scully v. Pacific States Savings & Loan Co. (9 Cir. 1937) 88 F.2d 384, 386-387, certiorari denied sub. nom. *Ellingson v. Pacific States Savings & Loan Co.* (1937) 301 U.S. 704.[8]

If FDIC claims that the $500,000 was dissipated during the few days prior to the closing of the Bank, it has the burden of establishing that fact (*American Surety Co. v.*

[7]See also *Blakey v. Brinson* (1932) 286 U.S. 254, 262-263, where the Court discussed augmentation with reference to an asserted *intentional* trust.

[8]See also *Bank of America Assn. v. California Bk.* (1933) 218 Cal. 261, 276, 22 P.2d 704, 710.

Jackson (9 Cir. 1928) 24 F.2d 768, 770; *Scully v. Pacific States Savings and Loan Co.* (9 Cir. 1937) 88 F.2d 384, 387). This it cannot do on the basis of a mere motion to dismiss.

Thus the facts alleged in the complaint give rise to a right of rescission and a constructive trust in favor of appellant and other depositors who may be similarly situated. The depositors who received illegal consideration for their deposits, on the other hand, are not entitled to such relief. The payment of such consideration "contributed to the insolvency of [the] Bank" (R. 9), and the doctrine of unclean hands prevents the recipients from obtaining equitable relief.

II. THE CLAIMS OF DEPOSITORS THAT RECEIVED ILLEGAL BOUNTIES SHOULD BE SUBORDINATED TO THE CLAIMS OF INNOCENT DEPOSITORS.

The bounties received by depositors named as defendants in the complaint were prohibited by law. Under section 19 of the Federal Reserve Act (Act of December 22, 1913, 38 Stat. 256, 270, as amended; 12 U.S.C. 371b)[9], the Board of Governors of the Federal Reserve System has specified the maximum consideration which may be paid by member banks on time and savings deposits. That consideration is found in Regulation Q of the Federal Reserve System (12 C.F.R. 217.0-217.6), as supplemented

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[9]At all pertinent times this statute provided:

"The Board of Governors of the Federal Reserve System shall from time to time limit by regulation the rate of interest which may be paid by member banks on time and savings deposits * * *" (49 Stat. 714, 715).

from time to time by publications in the Federal Register. The complaint alleges that the defendant depositors received consideration in excess of the legal rates (R. 4-5).

A. The district court erred in dismissing the depositors who received illegal bounties.

Appellant claims that the depositors it named as defendants joined in violations of Regulation Q (R. 4-5), and therefore should not be permitted to share equally with other depositors in the liquidation of the Bank's assets (R. 11). These defendants should be parties to the determination of whether in fact they received illegal bounties and whether such receipt is grounds for subordinating their claims to the claims of the innocent depositors. Rule 19 of the Federal Rules of Civil Procedure, as amended effective July 1, 1966, provides:

> "A person who is subject to service of process and whose joinder will not deprive the court of jurisdiction over the subject matter of the action shall be joined as a party in the action if * * * he claims an interest relating to the subject of the action and is so situated that the disposition of the action in his absence may (i) as a practical matter impair or impede his ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest."[10]

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[10] At the time the action was filed, the amendments to Rule 19 containing the foregoing provisions had not become effective. The amendments, however, restate the same principle which was recognized by this Court in *State of Washington v. United States* (9 Cir. 1936) 87 F.2d 421, 427-428 (see also 2 Barron & Holtzoff, Federal Practice and Procedure (1966 Pocket Part) p. 25; 3 Moore's Federal Practice (1966 Supplement) p. 150).

If the depositors whose claims appellant seeks to have subordinated are not parties to the action, their ability to protect their interests might be impaired; alternatively, if they are not parties, they might not be bound by a judgment subordinating their claims, and the receiver could be subjected to inconsistent obligations in liquidating the Bank's assets.

The district court nonetheless ignored the principles set forth in Rule 19 and based its dismissal on the ground that there is no Federal-question jurisdiction over those parties:

> "[A]s to all * * * defendants [other than FDIC] there appears no claim or cause of action asserted in the complaint which 'arises under the Constitution, laws or treaties of the United States' * * *."
>
> "(7) from what is alleged in the complaint, it appears that any claim or cause of action which plaintiff has against the defendants other than Federal Deposit Insurance Corporation is non-federal in character, arises under State law, and may be properly prosecuted in the State courts * * *" (R. 90-92).

Appellant's causes of action against those defendants do in fact arise under the laws of the United States and involve substantial Federal questions. They put directly in issue the interrelationship of two Federal statutes, section 19 of the Federal Reserve Act (12 U.S.C. 371b) and section 50 of the National Bank Act (12 U.S.C. 194), and the effect of these statutes upon the claims of those defendants to share ratably with appellant and others similarly situated in the distribution of the assets of an insolvent national bank.

Appellant's complaint also puts directly in issue the principles of equity that should be applied, as a matter of Federal law, in paying "ratable dividends" (12 U.S.C. 194) to achieve a just and proper distribution of assets in a national bank liquidation.

Appellant properly and clearly raised these Federal questions in all counts of its complaint. In paragraph IV of the first count, appellant alleged that the defendants dismissed by the lower court received directly or indirectly from San Francisco National Bank, as compensation for making or renewing their deposits, and in addition to interest at legal rates, "certain benefits, bounties or gratuities prohibited by law" (R. 4-5).

Appellant's third and fourth counts (R. 8-10) incorporate these allegations by reference and allege that the bounty takers should be subordinated to the innocent depositors in the distribution of the assets of San Francisco National Bank because those defendants acted in a manner contrary to public policy, i.e., the policy expressed in section 19 of the Federal Reserve Act (12 U.S.C. 371 b) and Regulation Q (12 C.F.R. 217.0-217.6), and because that policy should be enforced by subordinating the claims of the bounty takers to the claims of the innocent depositors.

The equitable principles that are to be applied in adjudicating the rights of depositors with respect to the distribution of the assets of an insolvent national bank are also matters of Federal law. In *Amer. Surety Co. v. Bethlehem Bank* (1941) 314 U.S. 314, the Court held:

> "The National Bank Act provides for the 'ratable' distribution of assets of insolvent national banks.

> R.S. §5236; 12 U.S.C. §194. The question for decision [the rights of a surety to share in the assets of a national bank] is therefore one of federal law. *Deitrick v. Greaney,* 309 U.S. 190, 200-201; *Merrill v. National Bank of Jacksonville,* 173 U.S. 131; *Davis v. Elmira Savings Bank,* 161 U.S. 275; *Cook County Nat. Bank v. United States,* 107 U.S. 445, 448. Congress has seen fit not to anticipate by specific rules solution of problems that inevitably arise in national bank liquidations. Instead, it chose achievement of a 'just and equal distribution' of an insolvent bank's assets through the operation of familiar equitable doctrines evolved by the courts" (314 U.S. 316-317).

B. Depositors who received illegal bounties should not be permitted to share equally with innocent depositors in the liquidation of the Bank's assets.

Those depositors who took bounties contributed to the failure of San Francisco National Bank. The Supreme Court has recently said that the prohibitions against paying interest on deposits in excess of legal rates were aimed at insuring sound banking practices (*U.S. v. Philadelphia Nat. Bank* (1963) 374 U.S. 321, 329). The only effective way to enforce the Federal policy prohibiting bounties, after a national bank has become insolvent, is to prevent the bounty takers from sharing in the bank's assets until the other depositors have been paid in full. Otherwise, the bounty takers may defy the law with impunity and pass the risk of their conduct to the other depositors, who will be forced to share with them in the remaining assets of the insolvent bank.

In another context, the Supreme Court has said that the National Bank Act may be invoked by the creditor for whose benefit it was enacted "in preventing the conse-

quences which the Act was designed to prevent'' (*Deitrick v. Greaney* (1940) 309 U.S. 190, 199). The most drastic consequences of violations of Federal banking laws is the closing of a national bank because of the wrongdoing of its officers and those with whom they did business.

Section 50 of the National Bank Act (12 U.S.C. 194), which provides for ''ratable dividends,'' permits consideration of the equities of the various claimants in deciding to whom a ''ratable dividend'' is to be paid. The Supreme Court has recognized that equity does not always require absolute equality among depositors. For example, equality yields to superior equity (*Scott v. Armstrong* (1892) 146 U.S. 499, 511), or to the ''obligation to do justice'' (*Rankin v. Emigh* (1910) 218 U.S. 27, 35). Thus, in providing for ''ratable'' distribution:

> ''Congress has seen fit not to anticipate by specific rules solution of problems that inevitably arise in national bank liquidations. Instead, it chose achievement of a 'just and equal distribution' of an insolvent bank's assets through the operation of familiar equitable doctrines evolved by the courts'' (*Amer. Surety Co. v. Bethlehem Bank* (1941) 314 U.S. 314, 316).

Other Federal courts have also recognized that the receivership of a national bank is in equity and calls for the application of equitable principles in the payment of claims (*General American Life Ins. Co. v. Anderson* (6 Cir. 1946) 156 F.2d 615, 621), and that the National Bank Act is to be given a liberal construction by the courts for the protection of creditors and depositors (*Grindley v. First Nat. Bank-Detroit* (6 Cir. 1936) 87 F.2d 110, 112).

In *Scott v. Armstrong* (1892) 146 U.S. 499, the Supreme Court, replying to an argument that an equitable setoff violated the "ratable dividend" provisions of the National Bank Act, pointed out:

> "The equity of equality among creditors is either found inapplicable to such set-offs or yields to their superior equity" (146 U.S. 511).

The Supreme Court has recognized the inequity of permitting a creditor to profit from his own wrongdoing. In *Taylor v. Standard Gas Co.* (1939) 306 U.S. 307, in a bankruptcy reorganization of a subsidiary corporation, the Supreme Court subordinated the parent company's claim as a creditor to the claims of other creditors and preferred shareholders of the subsidiary because of improper management of the subsidiary for the benefit of the parent. Although national bank liquidations are not governed by the Bankruptcy Act, the equitable principle that the claims of those whose acts caused or contributed to the failure of an enterprise should be subordinated to the claims of the innocent (*Taylor v. Standard Gas Co.* (1939) 306 U.S. 307, 322) is, we respectfully submit, particularly applicable to the case at bar.

CONCLUSION

For the foregoing reasons, we respectfully submit that the orders dismissing the defendant depositors and dismissing the action should be reversed.

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Certificate of Counsel

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Noble K. Gregory,
Attorney for Appellant American Telephone and Telegraph Company.

No. 21165

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

AMERICAN TELEPHONE AND TELEGRAPH COMPANY, *Appellant,*

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver, etc., *et al.,* *Appellees.*

VICTORIA SAVINGS AND LOAN ASSOCIATION, *Appellant,*

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver, etc., *et al.,* *Appellees.*

SECURITY SAVINGS AND LOAN ASSOCIATION, *Appellant,*

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION, Receiver, etc., *et al.,* *Appellees.*

Opening Brief of Appellant Victoria Savings and Loan Association.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

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Opening Brief of Appellant Victoria Savings and Loan Association.

Preliminary Statement.

This case involves the rights of depositors, including the holder of a cashier's check, to participate in the distribution of the assets of an insolvent national bank. It involves three basic questions: (1) whether an innocent depositor, including the person who obtained a cashier's check which was not cleared by the bank prior

to the time it was declared insolvent and taken over by a receiver, is entitled to a constructive trust on the assets of a bank where the deposit was fraudulently accepted by the bank and the cashier's check fraudulently issued by the bank, whose officers conceal from the depositor and the person obtaining the cashier's check the fact that the bank was then hopelessly insolvent, that its financial statements which it had issued were false, and that its officers were engaged in wrongful anr illegal acts; (2) whether the Federal Deposit Insurance Corporation (hereinafter referred to as FDIC) as insurer of the deposits in said bank and the assignee by way of subrogation from said depositors of the insurance paid up to $10,000 on deposits, should be subordinated in its claim as said assignee to the claim of the innocent depositors in the distribution of the bank's assets by virtue of certain wrongful acts of FDIC in connection with the operation of said bank and participating in keeping it open despite the knowledge that it was hopelessly insolvent; and (3) whether those depositors whose claims are based on certificates of deposit on which they were to receive illegal interest should be subordinated to innocent depositors in the distribution of the bank's assets.

Statement of Jurisdiction.

This action was initially brought by Appellant American Telephone and Telegraph Company (hereinafter referred to as Appellant AT&T) a depositor in the insolvent San Francisco National Bank (hereinafter referred to as SFNB), in the United States District Court for the Northern District of California against SFNB, FDIC (both as receiver of said bank and as insurer of the deposits in said bank) and numerous de-

positors including Appellant Victoria Savings and Loan Association (hereinafter referred to as Appellant Victoria) to prevent the bank's receiver, FDIC, from distributing the assets of the bank to those depositors whose wrongful acts contributed to the insolvency until innocent depositors, including Appellant AT&T, had been paid, and to impose a constructive trust on the assets of the bank in favor of said appellant [R. 1-12]. Appellant Victoria filed an answer in said action and a counterclaim against said Appellant AT&T and a cross-claim against all of the other co-defendants named by Appellant AT&T, excluding Appellant Victoria, seeking to impose a constructive trust on the assets of the bank in favor of Appellant Victoria, and, further, to prevent the bank's receiver, FDIC, from distributing assets of the bank to FDIC, as insurer and assignee of claims of depositors, or to depositors whose claims are based on certificates of deposit on which they received or were to receive illegal interest, until the innocent depositors, including holders of uncashed cashiers' checks, such as Appellant Victoria, have been paid [R. 15-34]. The District Court (Honorable William C. Mathes, Senior United States District Judge) on the Court's own initiative and without notice or hearing, dismissed the action, and all claims and counterclaims and cross-claims, for lack of jurisdiction over the subject matter as to all defendants and all counter-defendants and cross-defendants, other than defendant and cross-defendant FDIC, and, in exercise of its discretion, dismissed the defendant FDIC as receiver and as insurer of the depositors insofar as declaratory relief was sought, which dismissal specifically stated it did not operate as an adjudica-

tion upon the merits [R. 20-24]; denied the motions of Appellant AT&T and Appellant Victoria to vacate said order [R. 157-158]; and then granted the motion of FDIC to dismiss the entire action on the ground that it did not state a claim upon which relief could be granted, with leave to Appellant AT&T and Appellant Victoria to present their claims by seeking intervention, pursuant to Federal Rule of Civil Procedure 24, in Civil Action No. 43512, (N. D. of California) in the matter of the liquidation of the San Francisco National Bank.

The District Court had jurisdiction over the action, including the counterclaim and cross-claims of Appellant Victoria, under Section 1819 of Title 12 of the United States Code as to defendant and cross-defendant FDIC, which specifically provides:

> "All suits of a civil nature at common law or in equity to which the (Federal Deposit Insurance) Corporation shall be a party shall be deemed to arise under the laws of the United States."

It also had jurisdiction over the other defendants and cross-defendants pursuant to Section 1331 of Title 28 of the United States Code because "the matter in controversy exceeds the sum or value of $10,000, exclusive of interest and costs, and arises under the . . . laws . . . of the United States" and, further, said defendants and cross-defendants are interested in the subject matter and are proper parties thereto and, therefore, should be made parties to this action.

This Court has jurisdiction to hear this appeal pursuant to Section 1291 of Title 28 of the United States Code.

The Facts.

The facts set forth in the complaint of Appellant AT&T and cross-claims and counterclaim of Appellant Victoria must be accepted as true.

> *Atlantic and Gulf Stevedores, Inc. v. Donovan* (5 Cir. 1960), 274 F. 2d 794;
>
> *Williford v. People of California* (9 Cir. 1965), 352 F. 2d 474, 475.

On January 16, 1965, SFNB held $500,000 of funds belonging to Appellant Victoria and, in addition, owed Victoria $10,000. For said funds on said date it issued its cashier's check to Victoria in the amount of $360,000 on which the FDIC has since paid $10,000 to Victoria, being the amount of the insurance coverage on said deposit; and also, on said date, said bank issued its certificate of deposit in the amount of $150,000 to Appellant Victoria, for which Victoria was to receive only the legal rate of interest [R. 23]. Said cashier's check and said certificate of deposit were forwarded by said SFNB to Appellant Victoria by cover letter dated January 19, 1965, and received by Appellant Victoria in Riverside, California, on January 20, 1965 [R. 23]. Two days later, on January 22, 1965, the bank was declared by the Controller of Currency to be insolvent and the FDIC was appointed receiver [R. 23-24, 79, 433-434].

Some holders of certificates of deposit in SNFB at the time it was declared insolvent, and who are named defendants in this action, received directly or indirectly from SFNB, in addition to interest at the legal rate, compensation in the form of bounties for their deposits [R. 23, 433].

On January 14, 1965, Appellant Victoria requested SNFB to issue to it a cashier's check for $360,000, and a certificate of deposit for $150,000, for the five $100,-000 certificates of deposit issued by said SFNB which were held by Appellant Victoria and were due on January 16, 1965, plus $10,000 accrued interest thereon [R. 24]. On January 14, 1965, on January 16, 1965, the date that said SFNB dated the cashier's check in the amount of $360,000 in favor of Appellant Victoria, and also the certificate of deposit in the amount of $150,000, and on January 19, 1965, the date that said bank forwarded said certificate of deposit and cashier's check to Appellant Victoria said SFNB was insolvent, which fact was unknown to Appellant Victoria but was known to SFNB and its officers, as well as to the Controller of the Currency of the United States and to the defendant and cross-defendant FDIC; and, in addition, on each of said dates said SFNB and defendant and cross-defendant FDIC concealed from Appellant Victoria not only the true financial condition of said bank, but also that the bank officers had been engaged in activities impairing its financial stability and violating federal laws and regulations [R. 24 and 30-33].

Appellant Victoria rescinded its certificate of deposit dated January 16, 1965, and its cashier's check dated the same date, and demanded the return of the $510,000 represented by said certificate and said cashier's check [R. 25]. Except to the extent that the FDIC paid Appellant Victoria $10,000 insurance proceeds for that portion of its cashier's check protected by federal insurance. FDIC has refused to return said sum of $510,000 belonging to Appellant Victoria, or any part thereof

[R. 25]. Appellant Victoria filed a claim with FDIC as receiver for priority and preference in connection with the liquidation, for the sum of $500,000, plus interest in the amount of $110.99, which claim has been denied by said receiver [R. 25-26 and R. 436]. FDIC takes the position that Appellant Victoria is only entitled to share in the assets of the estate of SFNB on the same basis as all general creditors, including FDIC as insurer and assignee from certain creditors, and including depositors whose claims are based on certificates of deposit on which they received the illegal bounties from said bank [R. 436.]

Appellant Victoria's cross-claims and counterclaim filed in this action are substantially the same as the complaint filed by Appellant AT&T, excepting for certain factual differences with regard to times of deposits and the holding of a cashier's check, and excepting for Appellant Victoria's sixth count directed against the FDIC, as insurer and as receiver, to subordinate the claim of FDIC as insurer and assignee of insurance claims paid to depositors to the claim of Appellant Victoria by reason of certain illegal and improper acts of the FDIC as insurer [R. 29-33].

By the order dated April 13, 1966 and entered on April 18, 1966, Judge Mathes, to whom this case had been assigned along with many of the other cases arising out of the failure of the SFNB, issued an order [R. 90-94] on his motion and without notice or hearing [R. 93] dismissing the action as to all defendants and cross-defendants other than FDIC [R. 63-64]. This dismissal was on the ground of lack of jurisdiction over the subject matter as to all defendants and all counter-defendants and cross-defendants other than defendant

and cross-defendant FDIC, and as to said defendant was dismissed under the court's discretion insofar as declaratory relief is sought. This dismissal specifically did not operate as an adjudication upon the merits [R. 94]. Appellant AT&T and Appellant Victoria moved to vacate this order [R. 95-110 and 112-120]. Judge Mathes, again without a hearing, denied these motions, but stated that the order was entered without prejudice to the right of the dismissed defendants and cross-defendants, if so advised, to seek intervention, pursuant to Federal Rule of Civil Procedure 24, in Civil Action 43512, *In the Matter of the Liquidation of the San Francisco National Bank* now pending in the same court [R. 157-158], which order was dated May 25, 1966. On the same date Judge Mathes granted, also without hearing, the motion of defendant and cross-defendant FDIC to dismiss the remaining parts of the action, including the remaining parts of the cross-claims of Appellant Victoria [R. 155-156]. Said order also provided that the dismissal was granted with leave to the plaintiff and cross-claimants to present their claims by seeking intervention pursuant to Federal Rules of Civil Procedure 24 in Civil Action 43512, *In the Matter of the Liquidation of the San Francisco National Bank* then pending in the same court.

Appellant Victoria filed timely notice of appeal to the orders of Judge Mathes as follows: (1) Order dated and entered on May 25, 1966, dismissing the action, including the cross-claims and counterclaims of Appellant Victoria, (2) Order entered on April 18, 1966, dismissing action as to certain defendants and as to certain claims, and (3) Order dated May 25, 1966 denying motion of plaintiff and cross-claimant Victoria to vacate said order of April 18, 1966.

In accord with Judge Mathes' suggestion, Appellant Victoria and Appellant AT&T also filed petitions to intervene in the proceedings mentioned in the court's two orders, to wit, *In the Matter of the Liquidation of the San Francisco National Bank,* U.S.D.C. 43512 (hereinafter sometimes referred to as "the liquidation proceedings"). Judge Wollenberg denied these petitions by order dated July 7, 1966, and filed July 8, 1966, and Appellants Victoria and AT&T have filed timely notices of appeal to this Court from that order. Thus, Appellants AT&T and Victoria are placed in the intolerable position of having one judge of the District Court state that their claims concerning the liquidation of this national bank cannot be brought in Federal Court in a plenary proceeding such as they have done in the case on appeal herein, but should be brought in the liquidation proceedings brought by the receiver and pending in said Court, and another judge of the same court who was handling the liquidation proceedings stating that their claims cannot be brought in the liquidation proceedings, and thus inferring that they should have been brought in an independent action such as these appellants have brought in this action which is on appeal herein.

Specification of Errors.

Appellant Victoria hereby sets forth the specification of errors which it relies upon in this Appeal.

1. The District Court erred in dismissing the action, including the cross-claims and counterclaims of Appellant Victoria, and in denying the motion of said appellant to vacate said order, since Appellant Victoria was entitled to have determined therein its claim

to priority in the liquidation on the basis of a constructive trust since the insolvent bank received appellant's funds at a time when it was insolvent to the knowledge of its officers.

2. The District Court was in error in dismissing this action and the cross-claims of Appellant Victoria as to defendant FDIC on the ground that Appellant Victoria was entitled to have determined therein its claim to have the claims of defendant FDIC as insurer, subordinated to the claim of Appellant Victoria, due to improper and illegal acts of said defendant FDIC.

3. The District Court was in error in dismissing this action and the cross-claims of Appellant Victoria as to defendant FDIC as receiver, on the ground that Appellant Victoria was entitled to have the court approve its claim to priority in the liquidation of the national bank and a determination that said receiver held assets belonging to appellant and to turn said assets over to said appellant since said assets were obtained from Appellant only six days before the bank was declared insolvent and at a time that the bank was insolvent and known to be insolvent by its officers.

4. The District Court was in error in dismissing this action and the cross-claims of Appellant Victoria as to all defendants other than defendant FDIC since Appellant Victoria is entitled to have the claims of said defendants, which were based on certificates of deposit for which they received or were to receive illegal interest, subordinated to the claim of Appellant Victoria, and they are proper parties to the determination of said issue and further that they are proper parties to the determination of the first three errors specified herein.

Summary of Argument.

Appellant Victoria is entitled to a constructive trust upon the assets of SFNB in the amount of $500,000, which represents the cashier's check which was issued by said bank but was not cleared prior to the time the bank was declared insolvent by the Controller of the Currency, and the certificate of deposit issued by said bank, because at the time said bank issued its certificate of deposit and cashier's check in favor of Appellant Victoria, for funds of Appellant Victoria which it held, said bank was insolvent and fraudulently concealed its true financial condition from Appellant Victoria, and, further, fraudulently concealed certain illegal acts of said bank and its officers. The imposition of a constructive trust does not violate the requirement that assets of an insolvent national bank must be distributed pro rata. Appellant Victoria's funds augmented the assets of the bank and are traceable to those assets in the hands of the receiver.

As an alternative to such a constructive trust Appellant Victoria claims that it and other innocent depositors are entitled to a preference in the liquidation of the bank's assets over the claim of FDIC as insurer and assignee of depositors, and over certain depositors by reason of certain illegal and improper acts of said FDIC as insurer and by certain depositors. The FDIC and these depositors are proper parties to the determination of this issue since their interests are virtually affected thereby and by reason thereof they should be parties to this action.

ARGUMENT.

Excepting for minor factual differences, the complaint of AT&T and the cross-claim of Appellant Victoria are identical, except that Appellant Victoria has added a sixth count against defendant and cross-defendant FDIC seeking to have its claim in the liquidation as insurer and assignee of the claims of depositors on which it has paid the insurance coverage subordinated to the claim of Appellant Victoria on the ground that the FDIC as insurer participated in keeping SFNB open and in the renewal of certificates of deposit and issuance of the cashier's check, and in obtaining funds from the public, including Appellant Victoria, after the time in which it knew, or had reason to know, that the bank was hopelessly insolvent and, that the bank officials were engaged in certain illegal acts [R. 29-34]. A similar cause of action against the FDIC on the same theory was brought by the cross-claimants in the case of *FDIC v. AMR. Inc.*, United States District Court for the Northern District of California Case No. 43272, and was dismissed by order of Judge Mathes and said dismissal is presently on appeal to this court, Case No. 21237A.

I.

The Counterclaim and Cross-Claims of Appellant Victoria State Facts Which Entitle Said Appellant to a Constructive Trust on the Assets of the Bank Held by the Receiver and, Therefore, Entitle It to Priority in Payments to Be Made on Liquidation.

A. The SFNB's Fraudulent Acceptance of Appellant's Fund Is Ground for Imposing a Constructive Trust.

The general rule now is, and has been for many years in federal as well as in state courts throughout the

United States that the acceptance of deposits by a bank at a time in which it is hopelessly insolvent to the knowledge of its officers and unbeknown to the depositor constitutes fraud on the depositor and entitles the depositor to rescind and recover back the money or give him a preferential claim or create a trust *ex maleficio,* thus entitling him to priority in the liquidation.

> *Annotations* 20 A.L.R. 1206-14 and 81 A.L.R. 1078;
>
> *St. Louis & S.F.R. Co. v. Johnston* (1890), 133 U.S. 566, 576-578; 33 L. Ed. 683, 10 Sup. Ct. Rep. 390;
>
> *Wasson v. Hawkins* (1894), 59 Fed. 233;
>
> *Carnegie-Illinois Steel Corporation v. Berger* (3 Cir. 1939), 105 F. 2d 485, 487.

Appellant Victoria in its counterclaim and cross-claims alleges facts sufficient to impose the doctrine of constructive trust and to entitle it to priority in the liquidation over the claims of other creditors, including priority over FDIC in its corporate capacity.

Said appellant alleges [R. 23-24] that for the five $100,000 certificates of deposit issued by said SFNB for funds deposited by said appellant therein and which were due on January 16, 1965 plus $10,000 accrued interest thereon it on January 14, 1965 in writing sent said certificates properly endorsed to said bank and requested it to send its check for the sum of $360,000 and to issue a new certificate of deposit, for the sum of $150,000; that said bank did not honor the request of said appellant until January 19, 1965 when it sent to said appellant cashier's check of said bank dated January 16, 1965, in the amount of $360,000 and its cer-

tificate of deposit dated the same date in the amount of $150,000 which were received by said appellant on January 20, 1965; that two days after the receipt of said certificate of deposit and said cashier's check and at a time before the cashier's check had cleared said SFNB, the Controller of Currency on January 22, 1965, declared the bank insolvent and appointed defendant FDIC as receiver; that on January 14, (the date of the request for its funds), on January 16 (the date of the issuance of the cashier's check and certificate of deposit), and January 19, 1965 (the date of the mailing of said cashier's check and certificate of deposit to Victoria) said bank was insolvent, which fact was unknown to appellant Victoria but was known to said bank's officers and to the Controller of Currency of the United States and to the defendant FDIC and further that it was known to them that said bank officers had been engaging in activities impairing its financial stability and violating federal laws and regulations [R. 23-24].

A casher's check issued by a bank for funds received by the bank is until it is cleared by said bank deemed a deposit in said bank and was so treated in this case by defendant FDIC as insurer in paying the $10,000 insurance coverage on the $360,000 claim of appellant Victoria arising out of said cashier's check.

The counterclaim and cross-claims of appellant Victoria further allege that it rescinded the January 16, 1965, certificate of deposit and cashier's check and de-

manded that the receiver return the $500,000 represented thereby; that the receiver has refused to do so; that said appellant filed with defendant FDIC as receiver its proof of claim—priority and that the receiver has denied the same [R. 25-26]. It further alleges that said bank on January 16, 1965, by soliciting and accepting appellant Victoria's agreement to accept a certificate of deposit in the sum of $150,000 and a cashier's check in the sum of $360,000 under the circumstances that the bank at that time was then insolvent and said fact was known to its officers and not known to said appellant, perpetrated a fraud upon said appellant resulting therefore in a constructive trust in favor of appellant Victoria on the $500,000 of funds of said appellant held by said bank [R. 26-27].

Also a constructive trust may be imposed entitling a depositor in a bank to priority in the liquidation of an insolvent bank when the funds are received or held by the bank under circumstances which render it wrong or contrary to law and good conscience for the bank to accept or retain the deposit (*Tucker v. Newcomb* (4 Cir. 1933), 67 F. 2d 177, 179). It is submitted that the acts of other creditors who obtained illegal bounties for their deposits on which they have filed claims and the wrongful acts of the officials of the regulatory authorities including FDIC as set forth in the Sixth Cause of Action of appellant Victoria's cross-complaint are such that a constructive trust exists in favor of Victoria on the funds contained in said bank for the

amount of its claim, to wit, $500,000 over and prior to the claims of the other creditors including the FDIC.

Section 194 Title 12 of the United States Code provides for ratable distribution of the assets of an insolvent national bank. This section does not prevent the imposition of a constructive trust on certain assets of the bank since by the imposition of said trust there is a determination made that those assets rightfully do not belong to the bank. *Scott v. Armstrong* (1892), 146 U.S. 499, 510.

In an equitable receivership proceeding as well as in a statutory receivership proceeding such as is involved in this matter, the normal and usual equitable principles in determining priority claims in the liquidation of a bank must be followed. An examination of the annotations under Section 194, Title 12 United States Code Annotated shows that the doctrine of constructive trust and other related equitable doctrines permitting certain creditors to have priority in the liquidation of an insolvent national bank are applicable and are determined by the Federal Court. Subdivisions 61-120 of said annotated code set forth numerous cases considering the matter of priority claims, including a special section on the constructive trust doctrine when the bank was insolvent at the time the deposit was made.

The Supreme Court has recognized that in the distribution of assets of an insolvent national bank equitable principles govern, and that priorities may be granted where the facts justify the same irrespective of the ratable distribution provisions in the statute.

> *Scott v. Armstrong* (1892), 146 U.S. 499;
>
> *American Surety Co. v. Bethlehem National Bank* (1941), 314 U.S. 314.

B. The Renewal of Appellant Victoria's Certificate of Deposit in the Amount of $150,000 and Issuance to It of a Cashier's Check in the Amount of $360,000 on January 16, 1965 Augmented the Assets of the Bank for the Purposes of a Constructive Trust.

When SFNB on January 16, 1965 renewed $150,000 of the certificates of deposit which appellant Victoria had on deposit with said bank and which became due on said date and issued to it a cashier's check in the sum of $360,000 on the same date for the balance, it obtained funds of Victoria to use which it otherwise would not have been entitled and therefore the requirement of augmentation of the assets of the bank in order to impose a constructive trust have been met. *Federal Reserve Bank v. Idaho Grimm Alfalfa Seed G. Ass'n.* (9 Cir. 1925), 8 F. 2d 922, 928.

The Courts are more inclined to find an augmentation in cases of constructive trusts or trusts *ex maleficio* such as principal case. *Jennings v. U.S.F. & G. Co.* (1935), 294 U.S. 222-223.

C. Appellant Victoria's Deposit Is Traceable to Assets of the Bank Remaining After Insolvency.

The funds represented by the January 16, 1965, deposits in said bank, as evidenced by the cashier's check of said date and the certificate of deposit of said date may be clearly traced into funds acquired by the receiver six days later on January 22, 1965. When a fraud is committed by the bank when it received the assets of appellant Victoria on January 16, 1965, it had no right to commingle said assets with its other funds and a constructive trust is imposed on said assets and same are deemed to be maintained intact as the property of Appellant Victoria.

> *National Bank v. Insurance Co.* (1881), 104 U.S. 54, 69-70.

II.

The Claims of Appellant Victoria Present Federal Questions of Which the Federal Court Has Jurisdiction as to All Defendants.

On January 22, 1965, the SFNB was declared insolvent by the Controller of Currency of the United States and the FDIC was appointed receiver, both of which acts were done under federal law, this being a national bank. Section 191 of Title 12 of United States Code. It is the receiver's duty to liquidate said bank by collecting all of its assets and distributing the same to those entitled thereto. It has under federal law required all claimants of said bank to submit the claims to it. 12 U.S.C. 193. Said receiver must determine what assets properly belong to the bank and what assets belong to someone else. In so doing it is acting in its capacity as a receiver under the laws of the United States. If at the time of the insolvency due to the fault of the bank, assets are held of a person upon whom a fraud has been committed such as Appellant Victoria claims, then those assets do not belong to the bank, but belong to Appellant Victoria. The very imposition of the constructive trust doctrine as previously discussed herein involves a determination whether or not certain assets belong to the bank or belong by virtue of said doctrine to Appellant Victoria. *Scott v. Armstrong* (1892), 146 U.S. 499, 510. This claim for a constructive trust was presented by Appellant Victoria in writing in its claim duly filed with defendant and cross-defendant FDIC as receiver [R. 25-26]. The receiver has denied this claim and, therefore, Appellant Victoria, in order to establish the validity of its claim for priority, must bring an action

against the receiver who is the receiver appointed by and acting under Federal Laws. 12 U.S.C. 191.

In addition Appellant Victoria claims that it is entitled to priority over the claim of the defendant and cross-defendant FDIC as insurer and as assignee of the claims of depositors on which it has paid the insurance by reason of certain acts and omissions of said FDIC. Once again Appellant Victoria, in order to establish said claim, must bring an action against the FDIC. Clearly an action against the FDIC is one deemed to arise under the laws of the United States. 12 U.S.C. 1819.

Further, since the claims of other depositors in the bank will be affected by whether or not Appellant Victoria can establish its claim of a constructive trust and for priority over said other depositors, they are proper parties to this litigation.

> Rule 19 of the Federal Rules of Civil Procedure;
>
> *State of Washington v. United States* (9 Cir. 1936), 87 F. 2d 421;
>
> *Developments in the Law—Multi-Party Litigation in the Federal Courts.* 71 Harv. L. Rev. 874, 880-885 (1958).

Granting the relief requested by Appellant Victoria either as a constructive trust or by subordinating the rights of the other depositors to the claim of Appellant Victoria would have an injurious effect on said other depositors; therefore, they are proper parties.

The questions and issues presented in the complaint and the cross-claims involved in this case involve an interpretation of the provisions of Section 194 of Title 12 of the United States Code in connection with rata-

ble dividends. It also involves an interpretation of the effect of a violation of the provisions of Section 371b of Title 12 of the United States Code with regard to the interest rate that member banks of the Federal Reserve system may pay on time and savings deposits. Thus, issues are presented in the complaint and in the cross-claims involving federal statutes.

When a national bank is placed in receivership, federal law and federal questions are presented in connection with the distribution of its assets.

> *American Surety Co. v. Bethlehem Bank* (1941), 314 U.S. 314;
>
> *Chicago First National Bank v. Selden* (7 Cir. 1903), 120 Fed. 212;
>
> *Auburn Sav. Bank v. Hayes* (C.C. N.D. N.Y. 1894), 61 Fed. 911;
>
> *Downey v. City of Yonkers* (2 Cir. 1939), 106 F. 2d 69, affirmed 60 S. Ct. 796, 309 U.S. 590, 84 L. Ed. 694, rehearing denied 60 S. Ct. 1071, 310 U.S. 676, 84 L. Ed. 1420.

In *Auburn Sav. Bank, supra*, plaintiff, a state savings bank, brought an action in a state court against the receiver of an insolvent national bank to have its deposit in said insolvent bank paid in full rather than pro rata. On the motion of the defendant receiver the federal court ordered the action remanded to federal court since it was a controversy arising under the laws of the United States. It is submitted that this case raises substantially the same jurisdictional question as principal case and the relief sought by the plaintiff in said case is identical to the relief sought by Appellants AT&T and Victoria.

In *First National Bank of Chicago v. Selden, supra,* the court held that when a national bank has been placed in the hands of a receiver federal law becomes the law on the distribution of its assets and for the determination of whether a claimant is entitled to preference over other creditors.

Even if it were time, which Appellant Victoria does not concede, that some of the questions presented as against defendant other than the FDIC do not involve Federal questions, this Court would have ancillary or pendant jurisdiction to decide the same. They all involve the questions of the insolvent national bank and the priority of claims in liquidation thereof. *Siler v. Louisville & Nashville R.R. Co.* (1909), 213 U.S. 175.

Taussig v. Wellington Fund, Inc. (3 Cir. 1963), 313 F. 2d 472.

Appellant AT&T and Appellant Victoria both followed the suggestions contained in the Orders of Judge Mathes in dismissing this case without prejudice by petitioning to intervene to present their claims in the liquidation proceedings. The petitions of each of said appellants in connection with their claims in said liquidation proceedings were dismissed on motion of defendant FDIC herein, by Order of Judge Wollenberg dated July 7, 1966, and filed on July 8, 1966, on the apparent ground that Title 12, Section 192 of the United States Code under which the Receiver brought said proceeding for the approval of a transaction compromising certain assets of the Bank, does not permit an adversary proceeding between the Receiver and creditors, and that the creditors' sole remedy is that of a plenary suit. Both Appellant AT&T and Appellant

Victoria have filed appeals from said Order, which are presently pending in this court, case No. 21258C.

If the facts alleged in the complaint of Appellant AT&T and in the counterclaims and cross-claims of Appellant Victoria are true, which must be taken as true on the motion to dismiss, then they are entitled to relief as against defendant and cross-defendant FDIC, both in its capacity as receiver and as insurer, and said relief vitally affects the other defendants and cross-defendants, and, therefore, they are proper parties thereto; and since the relief sought involves interpretations of federal statutes and the rights and obligations of a federal agency, to wit, the FDIC, both as receiver and as insurer, and is a part of the liquidation of a national bank, the relief should properly be given by a federal court. This should be done either in this plenary suit, as requested by these appellants, or in the liquidation proceeding. It is indeed inequitable for the FDIC to argue in both this case and in the liquidation proceeding case that the claims of these appellants should be dismissed and, in effect, that they, therefore, have no legal remedy in the federal courts.

For the foregoing reasons Appellant Victoria respectfully submits that the orders of Judge Mathes appealed from be reversed, and that said appellant be permitted to proceed to trial on the merits of its claim.

Respectfully submitted,

Hahn & Hahn,
David K. Robinson,
By David K. Robinson,
Attorneys for Appellant Victoria Savings and Loan Association.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

David K. Robinson,

Appeal No. 21,165

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

AMERICAN TELEPHONE AND TELEGRAPH COMPANY, *et al.*, *Appellants*,

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION, etc., *et al.*, *Appellees.*

BRIEF OF APPELLEES:

A.M.R, Inc.; Alamo Savings and Loan Association; Altadena Federal Savings and Loan Association; American Federal Savings and Loan Association; Broadway Equities, Inc.; Burroughs Detroit Employees Credit Union; Charter Savings and Loan Association; Coachella Valley Savings and Loan Association; Columbia Savings and Loan Association; Community Federal Savings and Loan Association; Corning Glass Works Employees Federal Credit Union; Custer County Federal Savings and Loan Association; Dearborn Schools Credit Union; Designing Engineers Credit Union; Detroit Teachers Credit Union; First Federal Savings and Loan Association of Arkansas City; First Federal Savings and Loan Association of Manatee County; First State Bank of Bangs; First Western Savings and Loan Association; Flagler Federal Savings and Loan Association; Flint Teachers Credit Union; Friendship Federal Savings and Loan Association; Glendale Federal Savings and Loan Association; Hawthorne Savings and Loan Association; Home Federal Savings and Loan Association of East Rochester; Home Federal Savings and Loan Association of San Diego; Home Savings Association of Chanute, Kansas; International Union, United Automobile, Aerospace and Agricultural Implement Workers of America—UAW; Jervis Corporation Employees Credit Union; Kawneer Employees Credit Union; Lawrence-Cedarhurst Federal Savings and Loan Association; Library Credit Union; Marina Federal Savings and Loan Association; Mile High Savings and Loan Association; Monarch Savings and Loan Association; Nevada Savings and Loan Association; North American Investment Fund NV; Redwood Empire Savings and Loan Association; Rock Falls Savings and Loan Association; Shaker Savings Association; South Ferry Building Company; Union Federal Savings and Loan Association; Voice of Music Employees Credit Union; Westdale Savings and Loan Association; Western Savings and Loan Association.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Rules and Regulations

Appeal No. 21,165

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

AMERICAN TELEPHONE AND TELEGRAPH COMPANY, SECURITY SAVINGS AND LOAN ASSOCIATION AND VICTORIA SAVINGS AND LOAN ASSOCIATION, *Appellants,*

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION, etc., *et al., Appellees.*

BRIEF OF APPELLEES:

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Statement of Jurisdiction.

For its Statement of Jurisdiction, Appellees herein adopt the Statement of Jurisdiction contained in the Appellant's Opening Brief of the American Telephone and Telegraph Company, pages 2-3.

Statement of the Case.

This is one of a number of interrelated appeals now pending before this Court involving the distribution of the assets of the defunct San Francisco National Bank (hereinafter referred to as "SFNB").[1]

This brief is filed on behalf of certain appellees, all of whom were depositors in SFNB when its doors were closed on January 22, 1965 (R. [21165] 4) and who are thus claimants against the estate of SFNB. In the aggregate the claims of these appellees represent in dollar amount a majority of the claims against the estate—excluding the claims of the Federal Deposit Insurance Corp. (hereinafter referred to as "FDIC") and

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[1]These appeals, in order of the commencement of the actions in the Court below, are:

(1) The various appeals in No. 21237, which involve the legal validity of counterclaims filed by Appellees herein and other depositors in SFNB against FDIC asking that, on equitable principles, the claims of the FDIC against SFNB be satisfied after those of these depositors and that these depositors' deposits be adjudged to be held in constructive trusts.

(2) Appeals Nos. 21231, 21257, 21181 and 21191, which involve substantially the same questions as in (1) above, raised in independent actions filed by some Majority Depositors against both the FDIC and the District Bank.

(3) The instant appeal wherein the Telephone Company sued 88 other depositors in SFNB claiming individual priority over such depositors, and Security and Victoria filed counterclaims asserting individual priorities over other depositors.

(4) Appeals Nos. 21258-D and 21258-F, wherein some of the Appellees sought to intervene in the receivership proceedings of SFNB and were denied the right to do so on the ground that such proceedings were not judicial.

the Federal Reserve Bank of San Francisco (hereinafter referred to as "the District Bank") [Appendix A]. These appellees are herein referred to as "Majority Depositors".

Appellant American Telephone and Telegraph Company (hereinafter referred to as "the Telephone Company") was plaintiff below. Its complaint asserted two main claims:

First, that the Telephone Company is entitled to priority over the Majority Depositors (and other depositor defendants) in the distribution of the assets of SFNB (R. [21165] 9-10). This claim was grounded on allegations that the depositor defendants, as part of link-financing or money-brokerage transactions, received some benefit other than interest for making their deposits (R. [21165] 4-5). The Telephone Company alleges that each of the more than 80 defendants named by it received from SFNB, "as compensation for *making* or *renewing* . . . [their] deposits [it is not alleged that such were received for the *maintenance* of their deposits], in addition to interest at legal rates . . . certain benefits, bounties or gratuities prohibited by law," which "benefits, bounties or gratuities" the complaint proceeds thereafter to refer to as "bounties" (R. [21165] 4, line 72 to 5, line 2, emphasis added).

It alleges that it did not know that such benefits had been received *from SFNB* "or those acting on its behalf", and that *SFNB* had concealed the payment of such benefits from the Telephone Company. There is no allegation of any *facts* that would cause the payment of any such benefits to be illegal, or of any knowledge on the part of any defendants of facts that would cause any such payments to be illegal, or of any

duty on the part of SFNB to advise the Telephone Company that it or someone in its behalf had paid such alleged benefits (R. [21165] 5, line 29 to 6, line 7).

The allegations depart from a recitation of payments to depositors for the *making* or *renewal* (not *maintenance*) of deposits in typical link-financing and money-brokerage transactions (discussed, *infra*) in the statement that such were "prohibited by law", and from link-financing, though not necessarily from money-brokerage, in that allegedly such benefits were received "from the Bank". At one place in the complaint, however, this is qualified to state "from Bank, *or those acting on its behalf*", which presumably would include payments by SNFB borrowers for the placement of deposits in a typical link-financing transaction (R. [21165] 4, line 27 to 5, line 2; 5, line 29 to 6, line 1, emphasis added).

The complaint claims, secondly, that in any case the Telephone Company's deposit was the subject of a constructive trust because it was accepted—or its renewal was accepted—by SFNB when it was insolvent and known by its officers and directors to be so. On this basis, the Telephone Company asserted a priority over any other depositor who could not make the same showing (R. [21165] 7-8).

The complaint also claimed priority over the FDIC to the extent that it was subrogated to the claims of insured depositors who, but for the payment of Federal Deposit Insurance, would themselves have been subordinated on either of these theories (R. [21165] 9).

Security Savings and Loan Association (hereinafter referred to as "Security") and Victoria Savings and

Loan Association (hereinafter referred to as "Victoria") crossclaimed against the Majority Depositors and the FDIC, adopting in the main the Telephone Company's contentions (R. [21165] 15, 19).[2] This appeal is taken from the dismissal of the Telephone Company's complaint and the crossclaims (R. [21165] 159, 456, 457).

Though the Majority Depositors appear here as appellees, they are in accord with the appellants on a number of important points. In summary, it is their contention that the first of appellants' two claims is unfounded in law. The receipt by the depositor of a special benefit, other than interest, in connection with his deposit, whether through a link-financing or a money-brokerage transaction—even if proved—does not mean that his claim against the insolvent bank should be subordinated to those of depositors who did not receive such benefits.

The second claim, however, we think is sound. A deposit accepted or renewed when a bank is insolvent, and known by its officers to be so, is impressed with a constructive trust. This is certainly so where the making or renewal of the deposit was induced by affirmative representations as to the bank's solvency, known to be false by the bank's officers who made them, and relied on by the depositor. Holders of such deposits are entitled to priority over other claimants not similarly situated.

More fundamentally, the Majority Depositors here are in agreement with the Telephone Company that

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[2]Victoria's other contention is that because of the culpable conduct of the FDIC with respect to SFNB, Victoria is entitled to a preference over the FDIC in the distribution of the assets of SFNB (R. [21165] 30-31).

creditors of an insolvent bank have the right to a determination, in a judicial proceeding to which they may be parties, of the relative priorities of the claims against the estate of the bank. This is the meaning of the statutory command for a "ratable" distribution contained in 12 U.S.C. §194.

The effect, if not the intent, of the rulings in this and the related cases below has been to deprive the creditors of SFNB of any forum in which to try the issues of the relative priority of their claims, both as between the various private claimants and as between groups of private claimants and the FDIC. All the private creditors, on whatever side they appear in this case, are at one in asking this Court to redress this fundamental denial of the right to be heard.

Statement of Facts.

SFNB was chartered on May 1, 1961 and began operations on June 1, 1962 (Hearings, 69).[3] Outwardly, it appeared successful and prosperous. Nevertheless, from the very beginning of its existence gross irregularities and violations of law were present in the bank's operations (Hearings, 69-72, 483).

Appellant Victoria in this appeal, and Majority Depositors in related appeals, have alleged that by December 31, 1963, knowing of the insolvency of SFNB,

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[3]This reference is to the Transcript of Hearings on Investigation into Federally-Insured Banks before the Permanent Subcommittee on Investigations of the Senate Committee on Government Operations, 89th Congress, First Session (1965).

the FDIC, the District Bank and the Comptroller of the Currency as well as SFNB's directors, embarked upon a common course of conduct to keep SFNB open (R. [21165] 30-31; R. [21231] 3-5; R. [21257] 3-6; R. [21181] 2-4; R. [21191] 2-5). In pursuit of this course of conduct, these agencies sponsored the solicitation of deposits from Majority Depositors and others on the basis of falsified financial statements and misrepresentations. (R. [21165] 32; e.g., R. [21237]97).[4]

Late in 1964, the volume of deposits, even with this solicitation, became inadequate to keep SFNB open. Every banking day, from August 28, 1964, until January 22, 1965, the date on which SFNB was closed,

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[4]Direct participation in the solicitation of deposits for an insolvent bank through fraudulent financial statements and other misrepresentations is a step beyond any announced policy of the FDIC. Nevertheless, the stated policy of the FDIC shows something less than a sharpened conscience. In response to a Congressional questionnaire, with regard to disclosing to innocent members of the public the risk which may be entailed in depositing funds in a given bank, the FDIC stated:

> "The nature of banking and of the public interest in banks shape the procedural aspects of bank supervision in forms different from those encountered in other branches of administrative regulation. By reason of the fact that few banks operating at a profit can, upon demand, pay off its (sic) depositors in cash, there has been traditionally a policy of withholding from the public all information which either with or without justification, might provoke a depositors' run on a bank. Accordingly, depositors are not expected to exercise an informed individual judgment concerning the soundness of the bank in which they have deposited their funds, but must rely upon the vigilance and competence of the supervising authorities. As a corollary, the exercise of supervisory powers over banks has traditionally been attended by a secrecy antithetical to the publicity which marks most regulatory activities." Survey and Study of Administrative Organization, U.S. House of Representatives Committee on Government Operations, Part IIB (FDIC response to questionnaire) page 1401 (U.S. Government Printing Office 1957, No. 95899).

the District Bank, in close cooperation with the Comptroller of the Currency and the FDIC, made new loans to SFNB of funds necessary to keep SFNB's doors open, taking out $14 million of assets to secure a final $9.26 million of advances (Hearings, 243, 248, 281).[5]

The last such loan to SFNB was not made until January 22, 1965, the very last day of SFNB's life. This loan, in the amount of $1,300,000.00, enabled SFNB to make payment on a certificate of deposit to Lytton Savings and Loan Association in the amount of $1,500,000.00 plus interest. (Hearings, 251, 307-312). By exhausting the assets of SFNB that the District Bank would accept as collateral, the advance plus the Lytton withdrawal it made possible forced the seizure of SFNB that night (Hearings, 308-309).

In addition, a bank examiner's letter, recommending criminal proceedings, prepared in June, 1964, was held up seven months, until after SFNB was finally seized (Hearing, 251, 307).[5]

During all of 1964 and the first three weeks of 1965, the Majority Depositors and others, beguiled by and relying upon the false image of SFNB thus projected by misleading financial statements, misrepresentations, and the District Bank actions, either made new deposits or renewed or maintained existing deposits in SFNB when SFNB was, and knew itself to be, hopelessly insolvent (R. [21237] 59, 93, 103, 131, 142,

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[5]The District Bank was scrupulous with regard to the care that it exercised in selecting only the very best assets of SFNB grossly in excess of its advances as security for its loans and constantly went back to the portfolio to substitute new collateral for any that had proved substandard and to take out additional selected collateral, during all of which time the Majority Depositors have alleged SFNB was "hopelessly insolvent", which the District Bank knew. (R. [21231] 5).

153, 161, 172, 184, 196, 207, 217, 228, 229, 239, 249, 257, 269, 282, 289, 297, 309, 320, 327, 345, 357, 378-h). The agencies' actual appraisal of the situation was well expressed by the Comptroller of the Currency, by law one of the FDIC's three directors, who stated to the Senate Committee that by May of 1964 SFNB "was so murked down in just plain rot and corruption that there was *no hope.*" (Hearing, 108, et seq., emphasis supplied).

This course of conduct of the agencies prolonged SFNB's life while the agencies sought another bank willing to absorb SFNB by merger (Hearings, 100). A consequence of the prolonged life was to permit certain depositors, who were more fortunate or better informed or had better liaison with the agencies than either the appellants herein or the majority depositors, to withdraw their funds *in toto* instead of being compelled to share, *pro rata,* with the remaining depositors (Hearing, 251, 307).[6]

No creditor in any of these appeals seeks money damages at law for the harm which the FDIC has caused. They ask only that the Court below, as a court of equity to determine ratable distribution, take into consideration the position in equity of the FDIC as a corporate creditor claimant seeking to share ratably with the creditors it induced to place their moneys in

[6]Another consequence may have been to effect a substantial reduction in the FDIC's insurance of accounts liability with respect to SFNB. It is reasonable to suspect that during the last year or so of its existence the deposit situation of SFNB underwent a dramatic change. A large number of small local accounts were withdrawn to be replaced by a smaller number of large accounts. Since the FDIC's maximum liability under its insurance of accounts was, at that time, $10,000 per account, any reduction in the *number* of accounts was obviously to its advantage.

the insolvent SFNB (See, e.g., R [21237] 269, et seq.) (R. [21231] 1 et seq; R. [21258] 216 et seq.).

Statement of Issues.

Appellants state that for purposes of ruling upon the propriety of the District Court's action in dismissing their complaints and cross claims, all of the allegations in their pleadings must be assumed to be true (Tel. Co. Open. Br., P. 2; Victoria Open Br., P. 5). Appellee majority depositors concur.

But appellants understate their position. The issue before this Court is not only whether the allegations of appellants contained in their present complaints and cross claims would, if true, entitle them to the priorities which they seek. Rather, it is whether there is any reasonable prospect that the appellants could, if permitted to do so, amend to allege facts upon which any relief could be granted.

The position of the majority depositors is that the Court below erred in dismissing appellants' pleadings without leave to amend, and that appellants, as well as appellee Majority Depositors, have a right to an adjudication of relative priorities to the remaining assets of SFNB's defunct estate, including priorities *vis-a-vis* the FDIC as a corporate claimant against those assets. The majority depositors cannot in conscience, and therefore do not, contend that any creditor be refused a hearing on a contention of priority in the determination, by a court of equity, of ratability in distribution of the remaining assets of SFNB.

ARGUMENT.

I.

APPELLANTS SHOULD BE PERMITTED TO AMEND TO STATE CLAIMS FOR IMPOSITION OF CONSTRUCTIVE TRUSTS ON THEIR DEPOSITS AND TO SUBORDINATE FDIC'S CLAIMS.

The Telephone Company's claim is for $500,000 in deposits which matured and were renewed on December 28, 1964.[7] Victoria's claim is for a $360,000.00 cashier's check issued to it on January 16, 1965, and a $150,000.00 Certificate of Deposit issued the same day, both of which were issued to Victoria in consideration of five $100,000 certificates of deposit which matured on January 16, 1965 (R. [21165]5, 23-24).

The Telephone Company argues that the condition of SFNB on December 28, when its deposit was renewed, was such that the renewal was a fraud, giving rise to a constructive trust. (Tel. Co. Op. Br., p. 8). Victoria alleges that the bank was insolvent and knew itself to be such on January 16, 1965, when the cashier's check and $150,000 Certificate of Deposit were issued to Victoria. (R. [21165] 24).[8]

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[7]The Telephone Company does not state when its deposit in SFNB was made.

[8]The position of Victoria is slightly different from that of the Telephone Company and Security in that, on January 16, 1965, it withdrew the largest portion of its deposits. R. 24. Unfortunately for it, however, unlike Lytton Savings and Loan Association whose deposit matured six days later than Victoria's, it was paid not by telegraphic transfer of federal credits by the District Bank, but by SFNB's cashier's check through the mails. Before the check could be cashed, the SFNB was declared insolvent (Victoria Open. Br., p. 5).

If the condition of SFNB on December 28, 1964, was such, as alleged by the Telephone Company, that it could not accept or renew deposits, a payment by SFNB of the deposit to the Telephone Company would have constituted an unlawful preference (See 12 U.S.C. § 91). Victoria, too, in alleging that it received the cashier's check during SFNB's insolvency, necessarily admits that it was not entitled to withdraw that money on January 16, 1965. Nevertheless Victoria and the other appellants should be allowed to amend to state facts justifying the imposition of constructive trusts to give them priority over all creditors of SFNB not also able to establish such priority. If able so to amend and then to prove that their deposits have the status of special deposits, Victoria, and the other appellants, could achieve priority over those, not excluding the FDIC, who cannot on equitable principles establish their respective claims of special deposits.

In addition, totally apart from its right to prove that its own deposits are special deposits and therefore should be paid before other claimants who cannot establish such status, Victoria has stated or should be given an opportunity to state a case for subordinating the FDIC's claims on equitable grounds of the FDIC's culpable involvement in Victoria's loss.

II.

APPELLANTS HAVE NOT ALLEGED FACTS WHICH CHARGE THE MAJORITY DEPOSITORS WITH INEQUITABLE CONDUCT SUCH AS IS CONTEMPLATED BY 12 USC § 194 FOR SUBORDINATION OF MAJORITY DEPOSITORS' CLAIMS. NEVERTHELESS, APPELLANTS SHOULD BE GIVEN THE OPPORTUNITY TO AMEND THEIR PLEADINGS TO DO SO.

A. Appellants Should Be Permitted to Amend.

While the Telephone Company's complaint is divided into six counts, the factual allegations grounding its claim of preference over the majority depositors is set forth in the first Count: the Telephone Company charges that "as a compensation for making and renewing . . . [their] deposits, and in addition to interest at legal rates, each of these defendants . . . received directly or indirectly from Bank certain *benefits, bounties or gratuities* prohibited by law (*hereinafter collectively called "bounties"*) (R. [21165] p. 4, line 31 to p. 5, line 2; emphasis supplied); that the Telephone Company's "sole compensation for [its] deposit and for its renewals was the payment of interest at legal rates . . ." (*id.*, p. 5, lines 25-27); that when it "renewed its deposit on December 28, 1964, it was unaware that . . . [the defendants] had directly or indirectly received bounties from Bank, or those acting on its behalf, as consideration for making or renewing their deposits . . ." (*id.*, p. 5, line 29 to p. 6, line 2); that "Bank concealed the payment of said bounties . . .

from the Telephone Company (*id.,* p. 6, lines 6-7); that "[h]ad plaintiff known of the payment of the aforesaid bounties, it would not have renewed its certificate of deposit on December 28, 1964." *Id.,* p. 6, lines 10-12.*

The remaining counts add little to the substance of Count I: the defendants "acted in a manner contrary to public policy and, in effect, converted to their own use monies of innocent depositors through the medium of improper and illegal transaction with Bank." (*Id.,* p. 8, lines 26-29); "the payment of bounties contributed to the insolvency of the Bank and to plaintiff's loss . . . the payment of bounties . . . were contrary to public policy. . . ." (*id.,* p. 9, line 29, to p. 10, line 2).

The Telephone Company alleges no facts which would show that the receipt of so-called "bounties"—to use the Telephone Company's colorful but prejudicial terminology—was illegal. There is nothing wrong, *per se,* in receiving a "benefit, bounty or gratuity." Yet this is the gravamen of the Telephone Company's complaint.

Let us assume, *arguendo,* that the Telephone Company could amend to allege the payment of cash consideration to a church, or to a union or corporate defendant, for *making* a deposit, and that the total of the amount paid for the making of the deposit, plus the amount that *would have been paid* as interest had SFNB not been closed before the payment of any interest in the deposit, would have exceeded the percentage figure permitted to be paid *by the bank* as interest

*Presumably, had *any* depositor known of the *volume* of SFNB brokered and link financing deposits it would not have made its deposit.

on the particular category of deposit, the complaint should be dismissed unless it also contains allegations of special circumstances known to the depositor that would make the transaction wrongful.

The payment of consideration by a borrower from a bank to a depositor in link financing transactions is an established banking practice. Perhaps in its oldest form, link financing grew out of the requirement of a lending bank that its borrower maintain a certain part of the sum advanced as a "compensating balance."[9] A certificate of deposit, possibly non-interest bearing, might be issued by the bank to its borrower for this "compensating balance." The borrower could sell the certificate at a discount to a corporate treasurer or another buyer whose short-term requirements matched the term of the certificate. The corporate treasurer had the advantage of a bank deposit, and the borrower had the use of a greater part of his total borrowings. This practice antedated both Regulation Q and the Federal Deposit Insurance Act.[10]

After World War II, brokers became increasingly active in this field. The certificates of deposit issued by banks for this purpose were more likely to be interest-bearing. Corporations which had relatively pre-

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[9]See, for example, Robert G. Rodkey, *The Banking Process*, New York; The MacMillan Company, 1928, Ap. 180-181; Henry Thornton, *Substances of Two Speeches of Henry Thornton, Esq. on the Bullion Report,* 1811, p. 20, cited in Jacob Viner, *Studies in the Theory of International Trade*, 1937, p. 152; and Howard Whipple, "The Average Balance Theory: Is it Justified?" *American Banker's Association Journal,* May 1931.

[10]Richard Fieldhouse, *Certificates of Deposit* (Boston: Banker's Publishing Company 1962), p. 29. Richard Fieldhouse is a member of the staff of the Federal Reserve Bank of New York.

dictable periods of cash surplus before tax or dividend dates regularly purchased such certificates through the money brokers.[11] Savings and loan associations, which were permitted to include the amount of such certificates as "cash" for purposes of minimum liquidity requirements, constituted a large market.[12]

The purchase of certificates of deposit by savings and loan associations has been closely regulated by the Federal Home Loan Bank Board. An important consideration for a savings and loan association in determining whether or not to purchase certificates is whether certificates of deposit may be considered for purposes of satisfying the liquidity requirements imposed by the Federal Home Loan Bank Board. (12 C.F.R. 523.12(b).[13] For an excellent summary of the history of the regulations governing the purchase of certificates of deposit by savings and loan associations, see U.S. Savings & Loan League Federal Guide, pages 8172-8173. During the late fifties, the Board promulgated a regulation providing that certificates of deposit could not be considered as "cash" for purposes of savings and loan associations' liquidity requirements unless the association itself had made the deposit for which the certificate was issued. (Rules and Regulations of the Federal Home Loan Bank Board, 555.10 and 570.1, now rescinded).

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[11]See Jack M. Gutentag and Richard G. Davis, "Compensating Balances", Federal Reserve Bank of New York, Monthly Review XLII (December, 1961), pp. 205-210. By August, 1966, C/D money reached its peak of $18.5 Billion. N.Y. Times, Oct. 23, 1966, Sec. III, p. 1, col. 3.

[12]Lawrence T. Crumb, *Time Deposits in Present Day Commercial Banking,* University of Florida Press, Gainsville, Florida (1963), p. 31. 12 C.F.R. 556.1.

[13]The term "cash" shall mean cash on hand, and cash on deposit in banks, including Federal Home Loan Banks, which is not pledged as security for indebtedness.

It is reasonable to suspect that the imposition of the requirement that the association itself make the deposit for which the certificate is issued resulted in a greater role for the money broker, who would arrange for one who borrowed through him to compensate the depositor for making the deposit in the bank, and for identifying the deposit to the bank which would then give credit to the borrower for it as a compensating balance. Thereafter, in 1964, the use of certificates of deposit for purposes of savings and loan associations' liquidity requirements was further circumscribed. (12 C.F.R. 530.1)

The interest, if any, paid by a member bank on the certificate of deposit could not lawfully exceed the Regulation Q maximum (Regulations of the Federal Reserve System, 12 C.F.R. 217.3). No direct controls applied to the amounts paid by the borrower from any bank for the making of the deposit, either to the broker or the depositor. Repeated excessive payments or too great a total of such deposits might well—and in case of SFNB did—call for inquiry into the bank's lending and liquidity policies. Normally, however, only the federal agencies and the national bank itself, not any single depositor, would know that such a condition existed unless it was reflected on public financial statements.

A further development, specifically ruled to be lawful by the Comptroller of the Currency, was the employment of money brokers on a percentage commission by banks themselves to obtain time deposits (represented by certificates of deposit) rather than as compensating balances for specific loans. (National Banking Review, September 1964, p. 99). Among savings and loan associations there is a regulation limiting the

volume of savings accounts in such institutions so obtained through money brokers to five per cent (5%) of all withdrawable savings in an insured association. 12 C.F.R. 563.25(c). This is accompanied by severe limitations on the amount the association or a money broker might pay to the saver for *placing* his savings in the institution (as distinguished from interest or dividends on the savings). 12 C.F.R. 563.24. But these express regulatory or statutory controls apply to deposits in savings and loan associations. No comparable regulations applied to time deposits in commercial banks during the period here relevant.

Even more significant is the action of the FDIC. On February 3, 1965, twelve days after FDIC had closed SFNB, FDIC filed a complaint for declaratory relief against 87 holders of certificates of deposit in SFNB. The complaint asked for judgment that the FDIC was "not obligated to pay for, to or on behalf of, defendants, or any of them, any sum or sums or insurance pursuant to provisions of Federal Deposit Insurance Act". (R. [21237] 11, lines 6-8). This prayer was based upon the alleged receipt by the defendants of fees for placing certificates of deposit in SFNB, and was brought under the Federal Deposit Insurance Act.[14] Thereafter, however, the FDIC abandoned its complaint and paid off under its insurance of accounts obligation. (e.g. R. [21258] 73, 97). Such payment would necessarily have required a determination that the deposits were "in the normal course of business" (28 U.S.C. Section 1813(1)).

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[14]". . . in any case where the corporation [FDIC] is not satisfied as to the validity of the claim for an insured deposit it may require the final determination of a Court of competent jurisdiction before paying such claim". (12 U.S.C. 1821(f).)

Finally the legality of a depositor's accepting fees from a borrower in connection with a link financing transaction has been upheld by the court. *Farm Mortgage Trust Co. v. Wilson,* 110 Kan. 786, 205 Pac. 610, 612-613 (1922); *Farmers and Merchants Nat. Bank v. Foster,* 112 Kan. 141, 210 Pac. 490, 491 (1922).

The Telephone Company apparently sought to avoid this principle by alleging that the benefit which, *arguendo,* we are assuming was a fee for the placement of the deposit, in fact came from the Bank, and not from a third party. We know of no case which has held that it is wrongful for a depositor to accept such a benefit. Indeed, it has been expressly held that a depositor commits no wrong in accepting a fee which he believes comes from a borrower in connection with a link financing transaction, even though in reality the fee comes from the bank. *Pitts v. People Bank* (1924) 137 Miss. 240, 102 South. 279, 281:

> "It seems to be established on reason and authority that a depositor will not be denied protection under the Guaranty Law because the depositor was solicited by a third party, not an agent of the bank, and who, to advance his own interest, paid the depositor a bonus to procure the making of a deposit, and it seems clear that such would be the case where the bonus was actually paid out of the funds of the bank, *if the depositor had no such knowledge or agreement with the bank and no knowledge of the fact that the bank was paying the bonus.*" (102 South. 281; emphasis added).

The Telephone Company's complaint does not allege the necessary knowledge or belief by the defendant depositors.

While the appellants have not pleaded facts entitling them to a preference *vis-a-vis* the Majority Depositors, the Majority Depositors do not believe that this Court, with only pleadings before it, should find that there is no reasonable possibility that the appellants could amend to state a cause of action. The Majority Depositors are confident that they are innocent victims of gross wrongdoing in connection with SFNB and that the appellants will not be able to establish a claim for preference over them. Nevertheless, the Majority Depositors believe that the law entitles appellants to an additional opportunity to plead facts which, if true, would entitle them to such a preference.

B. There Is Original Jurisdiction in the Federal District Court.

Here, the cause of action which the appellants are attempting to assert obviously arises under Federal Law. Under 28 U.S.C. § 1331, "the district courts . . . have original jurisdiction of all civil actions arising under the . . . laws . . . of the United States." The appellants are asserting that they are entitled to a priority in the distribution of the assets of an insolvent national bank. The manner in which those assets are to be distributed is, as indicated in Section IA, *supra,* prescribed by Federal statute, 12 U.S.C. § 194. It is a matter of Federal Law for decision by Federal courts. *American Surety Co. v. Bethlehem Nat. Bank,* 314 U.S. 314 (1941).

> "The moment a national bank went into the hands of a receiver, *the Federal Law became the law of the distribution of its assets* . . ." (*Chicago First National Bank v. Seldon* (Ill. 1903) 121 F. Supp. 562, 565) (emphasis added).

> *"The distribution of the assets of an insolvent bank is controlled by the law enacted by Congress which requires a ratable distribution thereof."* (*Bryant v. Lynn County Or.* (D.C. Or. 1928) 27 F. Supp. 562, 565) (emphasis added).

The order dismissing the claims of the appellants for a lack of federal jurisdiction was clearly erroneous and should be reversed.

III.

THE CLAIM OF VICTORIA FOR PRIORITY OVER THE FDIC BASED ON THAT AGENCY'S IMPROPER COURSE OF CONDUCT IN CONNECTION WITH THE EVENTS LEADING TO SFNB'S FAILURE SHOULD BE ENTERTAINED IN ACCORDANCE WITH THE STATUTORY SCHEME FOR RATABLE DISTRIBUTION.

In its verified cross-complaint, Victoria alleges that "during 1964 cognizant agencies and instrumentalities of the Federal Government, including defendant Federal Deposit Insurance Corporation (hereinafter 'FDIC') came to know that Bank [SFNB] was insolvent or in imminent danger of insolvency . . ." These agencies thereupon "engaged in a course of conduct with bank management and with each other . . . in an effort to keep Bank open and to avoid disclosure of its true condition to the public . . . Such course of conduct was undertaken in order to induce defendant Victoria and others to make and/or maintain their . . . deposits in Bank . . . The course of conduct was intended to inure to the benefit of defendant FDIC, and specifically to permit the defendant FDIC to delay, reduce and conceivably to avoid altogether any liabilities on its in-

surance obligations which mature whenever an insured bank is closed on account of inability to meet demands of depositors." (R. [21165] 30-31). The cross-claim then goes on to describe a number of specific acts of misconduct by the FDIC and the agencies with whom it conspired.

Victoria's allegations against the FDIC are similar to the allegations of Majority Depositors in the related appeals now pending before this Court. Since the issues related to the statement of a cause of action are treated in considerable depth in these related appeals, appellants limit themselves here to a very abbreviated statement of legal bases for Victoria's claim. It is our view that decision on this question should be reserved until the companion appeals are disposed of.

The Majority Depositors are at a disadvantage in demonstrating what could have been alleged, if amendment had been allowed to Victoria in this case or to the Majority Depositors in the cases in the related appeals. The factual showing of the Majority Depositors in the Court below in Appeal Nos. 21231, 21257, 21181, 21191, and 21237-A was stricken from the records on appeal by the District Court, and this Court denied the motion of Majority Depositors to restore those portions of the records below to the records on appeal.[15]

The basic legal points, however, may be simply stated.

Federal law prescribes that the assets of an insolvent national bank are to be distributed ratably:

> "From time to time, after full provision has been made for refunding to the United States any

[15](Order on Motion to Restore Stricken Portion of record on appeal in Appeal Nos. 21237-A, 21231, 21251, 21181 and 21191, dated filed Nov. 16, 1966).

> deficiency in redeeming the notes of such association, *the Comptroller shall make a ratable dividend of the money so paid over to him by such receiver* on all such claims as may have been proved to his satisfaction or adjudicated in a court of competent jurisfiction . . ." (12 U.S.C. § 194) (emphasis added).

What is a "ratable" distribution? It is "a 'just and equal' distribution of an insolvent bank's assets through the operation of familiar equitable doctrines evolved by the courts." (*American Surety Company of New York v. Bethlehem National Bank, supra.* See also *Jenkins v. National Surety Co.,* 277 U.S. 258, 267 (1928); *Davis v. Elmira Savings Bank,* 161 U.S. 275, 284 (1896)).

Victoria has charged that the FDIC induced it by an improper and misleading course of conduct to deposit money in an insolvent bank. The effect of this fraud was to reduce the FDIC's insurance of accounts liability. In other words, the FDIC used Victoria as an unwitting "reinsurer" of SFNB's failure.

"The operation of the familiar equitable doctrines" requires that the FDIC should not be permitted to enjoy the fruits of improper conduct by getting a greater net realization from SFNB's assets at the expense of its victims than it would have received had it not been involved in such improper conduct.

IV.

IT WOULD BE PREMATURE FOR THIS COURT TO ATTEMPT TO FORMULATE GUIDELINES FOR THE GUIDANCE OF THE DISTRICT COURT AT THIS STAGE OF THE PROCEEDINGS.

It may be that, in remanding this matter to the District Court, this Court will wish to formulate guidelines for use by the District Court in determining the priorities of the various claims to the assets of SFNB, both in this case and in the related appeals. While the prospect of formulating such guidelines has a certain superficial appeal, the Majority Depositors respectfully submit that such guidelines are premature at the present stage of the proceedings.

In order for this Court to lay down guidelines which would be meaningful and helpful to the District Court, it must know, or be able to anticipate with reasonable accuracy, the facts bearing upon priority which the various claimants to the assets of SFNB will attempt to prove at trial. The Majority Depositors respectfully submit that this Court has not been presented with the necessary factual background.

First of all, the pleadings are imprecise. For example, the appellants in this case charge the Majority Depositors with receiving "benefits, bounties or gratuities." This comprehends an extremely broad range of factual alternatives. Some of the alternatives might, in conjunction with other facts not presently alleged by the appellants, give rise to a claim for subordination. Others are totally innocuous.

If discovery had been completed and the cases were ready for trial, the Court might be able to speculate, with some hope of success, as to the pertinent facts. But even the present pleadings do not place definite limitations upon the pertinent facts which the parties may wish to prove because the future amendment of the pleadings is a likely possibility.

Hence, any guidelines which the Court might wish to hand down at the present time would be of doubtful value and might actually impede the administration of justice. Suppose, for example, that the Court set forth an order of priority which omitted any reference to facts that a party offered to prove at trial. The District Court would then be faced with the question of whether the facts which the proffered evidence were to prove had been considered by this Court and rejected as immaterial, or whether it had merely failed to anticipate the facts. The risk of introducing an undesirable rigidity into the litigation is apparent.[16]

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[16]An appellate Court, presented with appeals at the pleading stage, might well be cautious in assuming that the Telephone Company anticipated no "benefits" except the prevailing interest rate in placing $500,000 in SFNB (see opp. cit. fn. 3, *supra*), and that a Bay Area financial institution which recites in its brief, filed more than two years after SFNB's seizure, that "Security has not submitted its claim to and therefore has not received from the Federal Deposit Insurance Corporation the $10,000.00 insurance proceeds to which it is entitled" (Open. Br. Appellant Security Savings and Loan Association, p. 2, item 2) has fully disclosed the extent of its involvement with SFNB. A "benefit", understood by the Majority Depositor to be compensation, from the borrower or broker in link financing, as above discussed, for the *making* of the deposit, if that is what the Telephone Company and Security are charging against St. Joseph's Church and the other 80-plus depositor-defendants, is, by contrast, an understandable motivation to placing a deposit in a distant bank.

Conclusion.

In any event should the Court decide to set forth guidelines for the determination of priorities, notwithstanding the considerations discussed herein, those guidelines should not be formulated until the related appeals have been heard. The guidelines will necessarily affect the claims asserted in the related appeals and elementary considerations of fairness require that the parties thereto be given the opportunity to be heard on a matter which will substantially, and perhaps irrevocably, affect their rights.

Respectfully submitted,

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Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Aaron M. Peck

APPENDIX "A".

Appellees	Amount of Deposit*
A.M.R. Inc.	$ 40,000.00
Alamo Savings & Loan, San Antonio, Texas	50,000.00
Altadena Federal Savings & Loan, Altadena, California	110,000.00
American Federal Savings & Loan, Fort Wayne, Indiana	20,000.00
Broadway Equities, Inc., New York, New York	10,000.00
Burrough Detroit Employees Credit Union, Detroit, Michigan	50,000.00
Charter Savings & Loan, Bellflower, California	10,000.00
Coachella Valley Savings & Loan, Palm Springs, California	600,000.00
Columbia Savings & Loan, San Fernando, California	100,000.00
Community Federal Savings & Loan, Riviera Beach, Florida	10,000.00
Corning Glass Works Employees Federal Credit Union	10,000.00
Custer County Federal Savings & Loan, Weatherford, Oklahoma	10,000.00
Dearborn Schools Credit Union, Dearborn, Michigan	10,000.00
Designing Engineers Credit Union, Dearborn, Michigan	25,000.00
Detroit Teachers Credit Union, Detroit, Michigan	50,000.00
First Federal Savings & Loan, Arkansas City, Kansas	50,000.00
First Federal Savings and Loan Association of Manatee County	100,000.00
First State Bank, Bangs, Texas	10,000.00
First Western Savings & Loan, Las Vegas, Nevada	500,000.00
Flagler Federal Savings & Loan, Miami, Florida	200,000.00
Flint Teachers Credit Union, Flint, Michigan	20,000.00

*The amount listed is principal only. In each instance interest is also due. Each deposit has been reduced, since the filing of the action below, by payment by the FDIC of $10,000. deposit insurance, giving the FDIC the right of subrogation to such amount. Such deposit insurance payments have been accepted without prejudice to the claim of constructive trust and priority over the FDIC for the unpaid amounts.

Appellees	Amount of Deposit
Friendship Federal Savings & Loan, Pittsburgh, Pennsylvania	100,000.00
Glendale Federal Savings & Loan, Glendale, California	1,500,000.00
Hawthorne Savings & Loan, Hawthorne, California	100,000.00
Home Federal Savings & Loan of East Rochester, Rochester, New York	100,000.00
Home Federal Savings & Loan of San Diego, San Diego, California	750,000.00
Home Savings Association, Chanute, Kansas	20,000.00
International Union, United Automobile, Aerospace and Agricultural Implement Workers of American—UAW	3,000,000.00
Jervis Corp. Employees Credit Union, Grandville, Michigan	10,000.00
Kawneer Employees Credit Union, Niles, Michigan	10,000.00
Lawrence-Cedarhurst Savings & Loan, Cedarhurst, L.I., New York	200,000.00
Library Credit Union, Detroit, Michigan	10,000.00
Marina Federal Savings & Loan, Los Angeles, California	10,000.00
Mile High Savings & Loan, Denver, Colorado	70,000.00
Monarch Savings & Loan, Los Angeles, California	10,000.00
Nevada Savings & Loan, Las Vegas, Nevada	200,000.00
North American Investment Fund, NV	50,000.00
Redwood Empire Savings & Loan, Petaluma, California	300,000.00
Rock Falls Savings & Loan, Rock Falls, Illinois	10,000.00
Shaker Savings & Loan, Shaker Heights, Ohio	350,000.00
South Ferry Building Co., New York, New York	10,000.00
Union Federal Savings & Loan, Pittsfield, Massachusetts	100,000.00
Voice of Music Employees Credit Union	10,000.00
Victoria Savings & Loan, Riverside, California	150,000.00
Westdale Savings & Loan, Los Angeles, California	50,000.00
Western Savings and Loan Association (successor to Home Savings and Loan Association of Phoenix, Arizona)	630,000.00

No. 21,165

IN THE

United States Court of Appeals
For the Ninth Circuit

American Telephone and Telegraph Company, Security Savings and Loan Association and Victoria Savings and Loan Association, *Appellants,*

vs.

Federal Deposit Insurance Corporation, etc., et al., *Appellees.*

BRIEF OF APPELLEES
FEDERAL DEPOSIT INSURANCE CORPORATION,
as Receiver of San Francisco National Bank, and
FEDERAL DEPOSIT INSURANCE CORPORATION,
as Insurer of Deposits in San Francisco National Bank

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO, CALIFORNIA

Subject Index

Table of Authorities Cited

Cases

Statutes

Texts

No. 21,165

IN THE

United States Court of Appeals

For the Ninth Circuit

AMERICAN TELEPHONE AND TELEGRAPH COMPANY, SECURITY SAVINGS AND LOAN ASSOCIATION and VICTORIA SAVINGS AND LOAN ASSOCIATION, *Appellants,*	
vs.	
FEDERAL DEPOSIT INSURANCE CORPORATION, etc., et al., *Appellees.*	

BRIEF OF APPELLEES
FEDERAL DEPOSIT INSURANCE CORPORATION,
as Receiver of San Francisco National Bank, and
FEDERAL DEPOSIT INSURANCE CORPORATION,
as Insurer of Deposits in San Francisco National Bank

PRELIMINARY STATEMENT

American Telephone and Telegraph Company (Telephone Company) sued a large number of parties. The defendants may be divided into two classes. The first class consists of three named parties, i.e., San Francisco National Bank (the Bank), Federal Deposit Insurance Corporation (FDIC) as receiver of

the Bank, and FDIC as insurer of the Bank's deposits. The other group consists of 88 depositors in the Bank.

The Pleadings

The complaint consists of five counts. The first count[1] alleges in substance that on January 22, 1965, the Comptroller of the Currency declared the Bank insolvent and appointed FDIC as its receiver; that plaintiff held a $500,000 certificate of deposit of the Bank, which was renewed on December 28, 1964; that the Bank was then insolvent or in imminent danger of insolvency; that the defendant depositors had received illegal interest in the form of bounties; that the Bank had concealed those facts and other illegal acts from plaintiff, which would not otherwise have renewed its certificate; that plaintiff had rescinded the renewal, and demands the $500,000. The second[2] and third[3] counts allege that the facts gave rise to a constructive trust, the second count being in favor of plaintiff, and the third being in favor of plaintiff and depositors who had not accepted bounties. The fourth count[4] alleges that plaintiff is entitled to a preference against bounty depositors and against FDIC as subrogee of such depositors to the extent of insurance paid by it to them on their deposits. The fifth count[5]

[1] Tr., 4-7.
[2] Tr., 7-8.
[3] Tr., 8-9.
[4] Tr., 9-10.
[5] Tr., 10-11.

seeks an injunction against any distribution by the receiver prior to adjudication of claims of the parties.

In its answer,[6] FDIC in substance denies that plaintiff is entitled to special rights and alleges that all the creditors are entitled only to ratable distribution.

Two of the depositors who filed answers included counterclaims and cross-claims. They are Victoria Savings and Loan Association (Victoria)[7] and Security Savings and Loan Association (Security).[8]

Victoria denied receiving a bounty, or that it should be subordinated to plaintiff;[9] and alleged that it too should be the beneficiary of any constructive trust.[10] As counterclaim and cross-claims[11] against plaintiff and the other defendants, it alleges that on January 20, 1965, it received from Bank a cashier's check for $360,000 and a certificate of deposit for $150,000 in place of deposits totalling $500,000 and accrued interest of $10,000; that the Bank was then insolvent and known to be so by its officers and FDIC but the fact was concealed from Victoria, which would otherwise have demanded cash; that Victoria has rescinded and demanded the $500,000 from the receiver; that the other defendants received bounties, and that Victoria is entitled to a constructive trust and prefer-

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[6]Tr., 77-89.
[7]Tr., 15-34.
[8]Tr., 191-208.
[9]Tr., 16, 18-19.
[10]Tr., 18.
[11]Tr., 20-34.

ence, and asks for injunction pending adjudication of rights. It adds a count[12] alleging wrongful acts by the Bank officials, the FDIC, the Comptroller of the Currency and the Federal Reserve Bank in the operation of the Bank, which it asserts should cause subordination of FDIC's claims as subrogee to the claims of innocent depositors.

Security by its answer alleges that it holds renewed certificates of deposit totalling $600,000, and that it received only the legal rate of interest.[13] It makes substantially the same allegations as Telephone Company regarding insolvency and regarding receipt of bounty by other depositors.[14] It denied that plaintiff is entitled to a constructive trust or preference, and claims that it is entitled to such against plaintiff and the other defendants; or that if plaintiff is entitled to superior rights, Security is similarly entitled.[15]

In its answer to the cross-claims of Victoria[16] and Security,[17] FDIC in effect reiterates the position taken by it in its answer to the complaint of Telephone Company. It denied the allegations of wrongdoing contained in Victoria's cross-claim. In addition, FDIC asserts some affirmative defenses including the defense that the claims of cross-claimants are barred by the Federal Tort Claims Act.

[12]Tr., 29-34.
[13]Tr., 191-192.
[14]Tr., 192-193.
[15]Tr., 194-202.
[16]Tr., 432-444.
[17]Tr., 62-74.

The Orders Appealed From

The appeals are from three orders, one of April 13,[18] and the other two of May 25, 1966.[19] One of the May 25 orders was merely a denial of a motion to vacate the one of April 13. We therefore limit our discussion to the other two.

The order of April 13 was made by Judge Mathes of his own motion. It dismissed the action and the cross-actions for lack of jurisdiction over the subject matter as to all defendants except FDIC, and as to FDIC it dismissed the same "in the exercise of the Court's discretion . . . insofar as declaratory relief is sought."

Then on May 25, in response to a motion of FDIC, it dismissed the action as to all parties, so that there was nothing left.

Three Appeals, and the Plan of this Brief

Three parties have appealed: plaintiff Telephone Company,[20] and defendants and cross-claimants Victoria[21] and Security.[22] Telephone Company and Victoria have each filed briefs, and Security has adopted Telephone Company's brief. Because of the similarity of the issues, and by stipulation and leave of court, appellee FDIC files this brief in response to the briefs filed on behalf of the three appellants.

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[18]Tr., 90-94.

[19]Tr., 155-156; Tr., 157-158.

[20]Tr., 457-458.

[21]Tr., 159-160.

[22]Tr., 469-470.

We will first respond to Telephone Company. We will then discuss any points relating specifically to Victoria or Security.

This brief of appellees is filed by FDIC in its two capacities. These two capacities rise from the statute of Congress which creates FDIC, 12 U.S.C. §§ 1811 et seq. As receiver, FDIC marshalls the assets and pays the liabilities of the bank's estate (12 U.S.C. §§ 192, 1821). In its separate capacity as insurer of deposits, FDIC pays insurance and is subrogated to the payee's claim against the bank's estate in the amount of the insurance paid (12 U.S.C. § 1821). As it liquidates the bank, FDIC as receiver must make ratable distributions to all creditors, including itself as subrogee (12 U.S.C. §§ 194, 1821). These two separate capacities of FDIC are recognized in *Freeling v. Sebring,* 296 F.2d 244 (10th Cir. 1961). This brief is therefore filed by FDIC in its capacity as receiver of the Bank, in regard to the appellants' claims against the estate of the Bank. The brief is also filed by FDIC in its own capacity as insurer of deposits, in regard to the appellants' claims against FDIC's subrogation rights.

Appeal of Telephone Company

SUMMARY OF ARGUMENT

Telephone Company says that, because of fraud of the Bank, it is not in the position of a mere general creditor of the Bank's estate but is entitled to recover its whole deposit by way of rescission or constructive trust.

It then makes the alternative contention that since it received no excess interest it is an innocent depositor, and that the claims of depositors who took illegal interest should be subordinated to the claims of innocent depositors until the latter have been paid in full. In its complaint it also alleges that FDIC as subrogee of bounty depositors has no greater rights than such depositors.[23]

In response, appellee's contentions are these:

As to constructive trust:[24]

1. The facts alleged in the complaint do not constitute the hopeless and irretrievable insolvency which is necessary for a constructive trust.

2. The transaction on which Telephone Company relies was not a deposit but the renewal of a previous deposit. Therefore, the assets of the Bank were not augmented, and in consequence of that fact the Telephone Company was not entitled to a constructive trust in any event.

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[23]Tr., 9-10.

[24]The test being the same for rescission as for constructive trust, we refer to both claims as for constructive trust.

As to subordination of claims of guilty depositors:

1. The fact that depositors received bounty is not ground for the asserted subordination of their claims as general creditors, because a private action does not lie for breach of the Federal Reserve regulation as to interest, and, apart from that, such subordination would be inequitable.

2. Even if the claims of guilty depositors were to be subordinated, FDIC as subrogee claimant is not similarly subordinated.

ARGUMENT

I

TELEPHONE COMPANY IS NOT ENTITLED TO A CONSTRUCTIVE TRUST

A. The Bank Was Not Hopelessly and Irretrievably Insolvent

The facts alleged in the complaint do not constitute hopeless and irretrievable insolvency.

Such insolvency is necessary for a constructive trust:

Brennan v. Tillinghast, 201 Fed. 609, 615 (6th Cir. 1913);

Byrd v. Ross, 58 F.2d 377, 378, 379 (S.D.Fla. 1932);

Illinois Cent. R. Co. v. Rawlings, 66 F.2d 146, 150 (5th Cir. 1933), cert. denied, 291 U.S. 668 (1934).

The principle is stated in *Byrd v. Ross,* above (p. 378):

"A bank which is, to the knowledge of its managing officers, hopelessly and irretrievably insolvent, cannot honestly continue its business and continue to receive the moneys of its depositors. Although the bank's officers entertain no actual intent to defraud, nevertheless, when they know that the bank is hopelessly and irretrievably insolvent and receive money deposits on the eve of its failure, they commit a fraud on a depositor who, in ignorance of the condition of the bank, deposits his money therein."

It is also stated in *Illinois Cent. R. Co. v. Rawlings,* above (p. 150):

"It is well settled that the receipt of deposits when a bank, within the knowledge of its officers, is hopelessly and irretrievably insolvent, is a fraud on the depositor, who has a right to rely on the assurance of ability to pay the deposits on demand which the open bank creates. Such receipt operates to prevent the creation of the ordinary relation of banker and depositor, making the deposit trust funds. (Citations) Since, however, the trust is created only when there is fraud, the burden rests on the depositor to prove, not that the bank was insolvent when the deposits were made, but that it was hopelessly and irretrievably so within the knowledge of its officers.

*   *   *   *   *   *   *

"The rule has its sound supporting reasons. A bank is organized to receive deposits, and while it is a going concern it must continue to receive them. 'For it is obvious that to refuse to accept deposits would be equivalent to a cessation of business.' (Citation) A no less imperative duty rests upon the officers of a bank to keep it open

> by receiving deposits, thus averting the losses that inevitably follow closing, than rests upon them to close the bank when it may no longer be kept open."

In a footnote, the court in the *Illinois Central* case quotes from *McDonald v. Chemical Nat. Bank,* 174 U.S. 610 (1898), as follows:

> "It is matter of common knowledge that banks and other corporations continue, in many instances, to do their regular and ordinary business for long periods, though in a condition of actual insolvency, as disclosed by subsequent events. It cannot surely be said that all payments made in the due course of business in such cases are to be deemed to be made in contemplation of insolvency, or with a view to prefer one creditor to another. There is often the hope that, if only the credit of the bank can be kept up by continuing its ordinary business and by avoiding any act of insolvency, affairs may take a favorable turn, and thus suspension of payments and of business be avoided."

The complaint here fails to meet this test. It alleges that at the time of the renewal of the deposit "Bank was then either insolvent or in imminent danger of becoming insolvent . . .".[25] As we have seen, insolvency is not enough; it must be hopeless and irretrievable. And "imminent *danger* of *becoming* insolvent" is not even insolvency. The fact that the Bank continued to operate for nearly a month[26] after the renewal is

[25]Tr., 66.
[26]Tr., 6.

further indication of the fact that at the time of the renewal the condition of the Bank was not hopeless or irretrievable.

B. Renewal of a Deposit Is Not Ground for a Trust, Because It Does Not Augment Assets

Telephone Company claims a constructive trust because of the transaction of December 28, 1964.[27] That was not a deposit but a renewal of a deposit. Therefore, it did not augment the assets of the Bank; and for constructive trust the Bank's assets must be augmented by the action of the depositor at the time the trust is claimed to have been created.

Hennemann v. Rosebud Bank, 78 S.W.2d 113 (Mo.App. 1935);

Mallett v. Tunnicliffe, 102 Fla. 809, 136 So. 346 (1931);

Luikart v. Schmidt, 138 Neb. 282, 292 N.W. 723 (1940);

Fagan v. Whidden, 57 F.2d 631 (5th Cir. 1932);

Venner v. Cox, 35 S.W. 769 (Tenn.Ch.App. 1895);

Barsness v. Tiegen, 184 Minn. 188, 238 N.W. 161 (1931);

Allied Mills v. Horton, 65 F.2d 708 (7th Cir. 1933);

Braver, *Liquidation of Financial Institutions,* pp. 39, 40 (1936).

References to a few of these cases illustrates the doctrine.

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[27]Tr., 7-8.

In the *Hennemann* case, a depositor sought payment of a certificate of deposit. The bank being unable to pay, he took a renewal certificate. When the bank failed, he claimed preference by a trust ex maleficio. Recovery was denied, the court saying (78 S.W.2d, p. 115):

> "The renewal was not in fact (whatever else it may have been in theory) the making of a new deposit. It was for the continuation of the former or original deposit under a new contract for an additional period of time. There was no actual money or other thing of value deposited in the bank by the plaintiff at such time or, upon plaintiff's theory, anything of value left therein by him. The plaintiff is not permitted to play fast and loose at pleasure. He did not, in fact, deposit anything in the bank upon that date; nor can he be permitted to say that he left a deposit in the bank from that date, which he had previously made therein, and at the same time say that the bank was insolvent and unable to pay such deposit. He cannot say that there was nothing in the bank to be left by him on that date, on which a claim for preference in his favor might arise, and at the same time assert a right to a preference as if it were there."

In the *Mallett* case, a depositor attempted to withdraw her savings deposit. She was dissuaded on the false representation that the bank was solvent. The bank closed 21 days later. The depositor sought to recover her deposit by impressing a trust. The court held that no trust was created. It said (136 So., p. 348):

> ". . . the depositor voluntarily and knowingly continued her relationship as a general depositor, or, in other words, as a general creditor of the bank. The fact that she did so through the fraud and deceit of an officer of the bank in inducing her not to change her relationship does not of itself convert the relationship from that of debtor and creditor to one of trustee and cestui que trust."

The court said that the case differed from the situation where a depositor was induced to *make a deposit* by false representations of solvency, in which situation the fraud prevented the title to the deposit from ever vesting in the insolvent bank.

In the *Luikart* case, the question was whether a renewal of a deposit absolved from liability persons who were shareholders at the time of the original deposit. The court said (292 N.W., p. 724):

> "To the depositor, certainly, it is pure fantasy to say that, when he renewed his certificate, the money was returned to him, and that he in turn passed it back over the counter to the bank. So far as he was concerned, there was but one controlling transaction, and that was when he parted with his money. The rest of it was incidental detail—collecting interest, and going to the bank to receive a substitute certificate or receipt, so that his interest payments would not be interrupted."

In the *Fagan* case, bank officials fraudulently concealed the existence of a deposit which would have been withdrawn if the owners had known of its existence. The court said (at p. 632):

> "That the officers of the bank have acted badly, and that for the damage caused by their fraudulent conduct they may be held personally to account, goes without saying. It is quite another thing, however, to say that the fraud of an officer of the bank, by which a depositor is prevented from carrying out a purpose to cease being a creditor of the bank converts him from a creditor of the bank into an owner of a specific amount of the bank's funds so that thereafter the bank is, as to that amount, not his debtor, but his trustee."

The case at bar is governed by those cases. What Telephone Company did on December 28 was not the making of a deposit but the renewal of a deposit. Hence it lacked the augmentation which is essential to creation of a constructive trust.

C. Appellant's Arguments Regarding Constructive Trust

As against these points, Telephone Company offers the following contentions.

Hopeless and Irretrievable Insolvency

It cites cases to the effect that receipt of a deposit by an insolvent bank is a fraud on the depositor entitling him to recover his deposit by way of constructive trust. As we have seen, however, to serve as a basis for a constructive trust the insolvency must have been hopeless and irretrievable. This appears not only in the cases cited by us but also in appellant's cases. For example, in *Carnegie-Illinois Steel Corporation v. Berger,* 105 F.2d 485 (3rd Cir. 1939), cert. denied, 308 U.S. 603 (1939), the court said (p. 487):

> "We think that the law may be stated as follows. If a bank accepts a deposit with knowledge upon the part of its officers and directors that it is hopelessly and irretrievably insolvent, there is a fraud perpetrated upon the depositor. The depositor may thereupon rescind the contract of deposit and recover the sum paid in or ask that a constructive trust be declared in his favor upon its proceeds."

Appellant cites *Tucker v. Newcomb,* 67 F.2d 177 (4th Cir. 1933), to the effect that constructive trust may be applied even where there is no insolvency if it was wrong for the bank to accept the deposit. The *Tucker* case is inapplicable factually, and its general principle is not the criterion here because here the basis of the claim is insolvency and there is specific law on the kind of insolvency which gives rise to the claim. Moreover, in the *Tucker* case there was an actual deposit at the time of the alleged wrong.

Lack of Augmentation

Telephone Company does not cite any case holding that renewal of a deposit augments the estate. In an endeavor to present analogies, it cites cases which are, however, wholly lacking in analogy. Thus, in *Federal Reserve Bank v. Idaho Grimm Alfalfa Seed G. Assn.,* 8 F.2d 922 (9th Cir. 1925), cert. denied, 270 U.S. 646 (1926), the question of augmentation was not involved, and the depositor was not seeking to enforce a trust or to follow trust funds but was suing in tort for which, as this Court said, a court of law affords a complete remedy.

In *American Nat. Bank v. Miller,* 229 U.S. 517 (1913), the payee of a check, instead of sending it through the clearing house sent it directly to the drawee bank where the payee maintained an account. The latter, shortly after receipt of the check, credited the payee's account and debited the maker's account. Thereafter, the drawee bank, learning that the maker had become insolvent, tried to cancel the credit so as to be able to offset the maker's account against a debt of the maker to the drawee bank. The basis of the drawee's claim that it should be able to rescind the credit entry to the payee's account was that the payee had fraudulently concealed the maker's insolvency. The court held against the drawee bank, however, because the payee had no knowledge of the insolvency. And the statement in the opinion that the crediting of payee's account was equivalent to payee receiving the money from drawee and then passing it back for deposit had nothing to do with trust or augmentation. It was merely a statement supporting the court's observation that when the drawee bank made the credit the process of collection was closed.

We will not consume the court's time with a particular discussion of the other cases, but a reading of them shows that they are inapplicable to the case at bar because they basically concern themselves with the check collection process and do not in any way involve certificates of deposit or renewals thereof.

Tracing of Assets

Appellant states that the December 28 deposit may be traced into the assets of the Bank since the Bank

committed a fraud upon appellant and thus had no right to commingle the deposit with other funds. But this assumes the augmentation resulting from a deposit whereas we contend that the December 28 renewal did not constitute a deposit.

II

TELEPHONE COMPANY IS NOT ENTITLED TO SUBORDINATION OF THE CLAIMS OF OTHER CREDITORS

As an alternate claim for reversal, Telephone Company says that since it received only the legal rate of interest, defendant depositors, who received an illegal rate or bounty, should be subordinated to it and to other innocent depositors. Though it does not treat the subject in its brief, it alleges in the complaint[28] that FDIC as subrogee of such depositors has no higher rights than they have.

A. Defendant Depositors Should Not Be Subordinated

Telephone Company's argument on this point is this. The Board of Governors of the Federal Reserve System are empowered by 12 U.S.C. § 371(b) to limit the rate of interest payable by national banks on time and savings deposits. Pursuant to that authority, the Board has specified that maximum amount of interest. It did so by what is called Regulation Q of the Federal Reserve System. The complaint alleges that the defendant depositors received consideration in excess of that rate. On that ground, Telephone Company seeks subordination of the claims of depositors receiving such illegal rate of interest

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[28]Tr., 9-10.

to the claims of Telephone Company. This amounts to saying that as a private litigant Telephone Company can bring a private action for violation of Regulation Q.

The answer to this contention is that the Federal Reserve regulations do not create a private cause of action. Rather, Congress intended that the regulatory controls under the Federal Reserve System be exercised solely by the Board of Governors or the Comptroller of the Currency. This was the holding of *Blaney v. Florida National Bank at Orlando,* 357 F. 2d 27 (5th Cir. 1966). Therefore, this claim of Telephone Company cannot be sustained.

Apart from that, Telephone Company's claim fails. It bases its contention regarding bounty depositors chiefly on the ground of equity. It says that it is unfair for depositors who violated the law by receiving illegal interest to share equally with depositors innocent of such a wrong.

It would be a harsh equity that would punish a depositor who received some extra interest by nullifying his entire claim to his deposit. That is what it would amount to; that is, if the claims of depositors who received any extra interest were to be subordinated until the claims of all other depositors were paid in full—which is what Telephone Company is contending—the former class of depositors would probably get nothing. This means that if a person with a million dollar deposit had received an extra half per cent of interest or an equivalent bounty, he would forfeit his whole million. That would not be equity; it would be a gross inequity.

Therefore, the only basis for such a result would have to be a statute. But there is no statute to that effect. The statute, on the contrary, says that claims are to be paid ratably. 12 U.S.C. § 194.[29]

B. FDIC Should Not Be Penalized

Even if a bounty depositor should be thus penalized, FDIC should not. FDIC is a creditor by virtue of having paid insurance on deposits. It is subrogated to the depositors' rights to that extent; but it is in that position by virtue of the duty imposed on it by law to pay insurance. In view of its mandatory duty and of its lack of connection with illegal interest, it would be inequitable to penalize it; and preservation of FDIC's right of subrogation also serves the public interest in that it protects the liquidity of FDIC's insurance fund.

For the reasons stated, the orders of the District Court should be affirmed as to Telephone Company's complaint against FDIC.

We will now discuss the appeals of Victoria and Security.

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[29]Section 194 provides:

"From time to time, after full provision has been first made for refunding to the United States any deficiency in redeeming the notes of such association, the comptroller shall make a ratable dividend of the money so paid over to him by such receiver on all such claims as may have been proved to his satisfaction or adjudicated in a court of competent jurisdiction, and, as the proceeds of the assets of such association are paid over to him, shall make further dividends on all claims previously proved or adjudicated; and the remainder of the proceeds, if any, shall be paid over to the shareholders of such association, or their legal representatives, in proportion to the stock by them respectively held."

Appeal of
Victoria Savings and Loan Association

In respect of the claim for constructive trust, Victoria presents substantially the same issues as Telephone Company. There were a couple of factual differences, but they did not affect the legal issues. The factual differences were that Victoria, which had five certificates of deposit for $100,000 each, did not renew the whole $500,000, but took a renewal certificate for $150,000, and took the balance of $350,000 plus $10,000 accrued interest in the form of a cashier's check; and the new certificate and cashier's check were dated January 16, 1965, and were received by Victoria on January 20.[30]

As against Victoria, therefore, this appellee reasserts the same contentions that it has made against Telephone Company regarding constructive trust, namely lack of the hopeless and irretrievable insolvency that is necessary for a constructive trust, and lack of augmentation of assets.

As we have seen, no augmentation results from the renewal of a certificate of deposit. The same is true of the issuance of the cashier's check. In both instances, the relationship between the Bank and the depositor remains the same, namely that of debtor and creditor. The effect of a cashier's check is described in *Clark v. Chicago etc. Co.,* 186 Ill. 440, 57 N.E. 1061 (1900), wherein the court said (57 N.E., p. 1062):

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[30]Tr., 16, 23-24.

> "The drawing of the cashier's check, even if it changed the form of indebtedness, did not change the fact. The Globe Savings Bank was still indebted to the appellant for the $3,000 represented by its cashier's check. There was no change in the nature of the debt. The only change was in the evidence of it."

In seeking subordination of claims, Victoria makes some charges against FDIC in its capacity as insurer rather than as receiver. It does so in the sixth count of its cross-claim.[31] In that count, Victoria, seeking to subordinate the claims of FDIC to those of innocent depositors, alleges substantially as follows:

It calls FDIC, the Comptroller of the Currency, and Federal Reserve Bank "responsible agencies," and it alleges:

> "The responsible agencies have different specific functions concerning the banking system, which are interrelated and are required to be exercised in conjunction with each other and with full coordination among the responsible agencies involved, all with a view to promoting a safe and sound banking system and providing assurance for depositors that they may deal with banks with full confidence that they are soundly and prudently operated."[32]

It also alleges:

> "During and throughout 1964 the responsible agencies, each having or being chargeable with knowledge that BANK was insolvent or in immi-

[31] Tr., 29-33.

[32] Tr., 30.

> nent danger of insolvency, engaged in a course of conduct with BANK management and with each other, each taking actions in the exercise of their respective authority and coordinating their respective actions, in an effort to keep BANK open and to avoid disclosure of its true condition to the public, including existing and prospective depositors."[33]

It alleges that the course of conduct was undertaken to induce Victoria and others to make and maintain their deposits in the Bank, and that, relying thereon, Victoria acted to its detriment in making deposits; that the course of conduct was intended to inure to the benefit of FDIC to permit it to delay, reduce and conceivably avoid altogether any liability on its insurance obligations. It alleges that the responsible agencies "however much they may have acted in the belief that their actions were in the public interest" were aware of the potential damage to depositors; and it alleges further acts of the so-called responsible agencies which it claims misled the public as to the condition of the Bank.[34]

Appellee vigorously denies such allegations, and here treats them as true only for the sake or argument. So considered, no such action lies for them, for two reasons:

> 1. The claim comes under the Federal Tort Claims Act, and as such it is barred because FDIC is a federal agency and suits coming under

[33]Tr., 30-31.
[34]Tr., 31-33.

that Act must be brought against the United States rather than the agency; and even if it were brought against the United States, it would be barred by § 2680(h) of the Act because it is a claim for misrepresentation or deceit, and it would also be barred by § 2680(a) of the Act because it is a claim based upon the exercise of a discretionary function by a federal agency.

2. Even apart from the Tort Claims Act, such a suit is barred by the principle that the performance by executive officers of discretionary governmental duties entrusted to them by statute is not subject to judicial review.

We treat these points in the order mentioned.

I

VICTORIA'S CLAIM FOR SUBORDINATION OF FDIC IS BARRED BY THE FEDERAL TORT CLAIMS ACT

A. Suits Brought under the Tort Claims Act Must Be Brought against the United States, Not against the Federal Agency Involved

In 1946, Congress enacted the Federal Tort Claims Act, which act permits the government to be sued for certain torts. It is Chapter 171 of Title 28 of the U. S. Code.

The underlying section is § 2674, which provides:

> "The United States shall be liable, respecting the provisions of this title relating to tort claims, in the same manner and to the same extent as a private individual under like circumstances. . . ."

Prior to enactment of the Tort Claims Act, certain federal agencies could be sued in tort. This was by virtue of statutes which provided that those particular agencies could sue and be sued. One of the effects of the Tort Claims Act, however, was that after its enactment such suits could no longer be brought against the federal agencies themselves but had to be brought against the United States. In this respect, 28 U.S.C. § 2679(a) provides:

> "The authority of any federal agency to sue and be sued in its own name shall not be construed to authorize suits against such federal agency on claims which are cognizable under section 1346(b)[35] of this title, and the remedies pro-

[35]Section 1346(b) provides:

"(b) . . . the district courts . . . shall have exclusive jurisdiction of civil actions on claims against the United States,

vided by this title in such cases shall be exclusive."

Federal Deposit Insurance Corporation is a federal agency, within the meaning of § 2671[36] of the Tort Claims Act and as such it is entitled to the protection of the Act. *Freeling v. Federal Deposit Insurance Corporation,* 221 F.Supp. 955 (W.D.Okla. 1962) aff'd per curiam, 326 F.2d 971 (10th Cir. 1963); *James v. Federal Deposit Insurance Corporation,* 231 F.Supp. 475 (W.D.La. 1964); *Edelman v. Federal Housing Administration,* 251 F.Supp. 715 (E.D.N.Y. 1966). Therefore, since the suit is not against the United States, the suit fails.

B. Even If Brought against the United States, the Suit Would Fail because It Would Be Barred by Sections 2680(h) and 2680(a) of the Act

Moreover, even if the suit had been filed against the United States, the Federal Tort Claims Act, although recognizing governmental tort liability, excludes certain torts from those for which the government may be sued. Among those excluded are

for money damages, accruing on and after January 1, 1945, for injury or loss of property, or personal injury or death caused by the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office or employment, under circumstances where the United States, if a private person, would be liable to the claimant in accordance with the law of the place where the act or omission occurred."

[36]Section 2671 provides:

"As used in this chapter and sections 1346(b) and 2401(b) of this title, the term 'Federal agency' includes the executive departments, the military departments, independent establishments of the United States, and corporations primarily acting as instrumentalities or agencies of the United States, but does not include any contractor with the United States."

misrepresentation and deceit. This appears in § 2680, which reads:

> "The provisions of this chapter and section 1346(b) of this title shall not apply to—
>
> *   *   *   *   *   *   *
>
> (h) Any claim arising out of . . . misrepresentation, deceit . . ."

In other words, while the government permits itself to be sued for certain torts—notably for injuries to person and property—it expressly declines to expose itself to liability for misrepresentation or deceit. Victoria's claim against FDIC is based upon charges of misrepresentation or deceit. Therefore, it is expressly barred by the statute.

It is also barred by Section 2680(a) which provides:

> "The provisions of this chapter and section 1346(b) of this title shall not apply to—
>
> "(a) Any claim . . . based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused."

As we have seen, Victoria expressly alleges that FDIC's alleged acts were done in the exercise of its authority; and they were manifestly discretionary acts. The Supreme Court in *Dalehite v. United States,* 346 U.S. 15 (1953), said that where there is room for policy judgment and decision there is discretion. In that respect, the court said (p. 35):

> "It is unnecessary to define, apart from this case, precisely where discretion ends. It is enough to hold, as we do, that the 'discretionary function or duty' that cannot form a basis for suit under the Tort Claims Act includes more than the initiation of programs and activities. It also includes determinations made by executives or administrators in establishing plans, specifications or schedules of operations. Where there is room for policy judgment and decision there is discretion. It necessarily follows that acts of subordinates in carrying out the operations of government in accordance with official directions cannot be actionable."

Therefore Victoria's claim for this relief is barred by § 2680(a).

The authorities support this conclusion. In *Schmidt v. United States,* 198 F.2d 32 (7th Cir. 1952), a shareholder of Tucker Corporation brought suit complaining of the conduct of the Securities and Exchange Commission (SEC). It was alleged that Tucker's automobile business was destroyed by a conspiracy of SEC and others, that SEC gave adverse publicity to Tucker, threatened publicly to investigate the concern and in fact did so investigate; that the conduct of the SEC allegedly violated the antitrust laws and also constituted a common law tort of willful business injury. The court held that all of SEC's actions were discretionary in character and that in consequence the suit was barred by the Federal Tort Claims Act. To the same effect with respect to discretionary acts of the SEC is *Holmes v. Eddy,* 341 F.2d 477 (4th Cir. 1965).

The fact that the acts complained of by Victoria were those of a combination of three "responsible agencies" does not take the matter out of the exception for discretionary acts. *Radford v. United States,* 264 F.2d 709 (5th Cir. 1959).

Nature of the Claim

On its motion to dismiss which led to the May 25 order of the District Court, appellee raised the point of the bar of the Tort Claims Act.[37] In reply, Victoria contended that the Tort Claims Act was inapplicable because this was not a claim for "money damages."[38] The phrase "money damages" appears in § 1346(b),[39] which we have quoted above. For the Court's convenience, we repeat it here:

> "(b) . . . the district courts . . . shall have exclusive jurisdiction of civil actions on claims against the United States, for *money damages,* accruing on and after January 1, 1945, for injury or loss of property, or personal injury or death caused by the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office or employment, under circumstances where the United

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[37]Tr., 126-127.

[38]Tr., 138.

[39]Section 1346(b) is pertinent to the Tort Claims Act because of reference to it in two sections of the Act, namely in the above quoted § 2679(a), which provides that "The authority of any federal agency to sue and be sued in its own name shall not be construed to authorize suits against such federal agency on claims which are cognizable under section 1346(b) of this title, and the remedies provided by this title in such cases shall be exclusive", and in the above quoted § 2680, which provides that "the provisions of this chapter and § 1346(b) of this title shall not apply to [certain enumerated kinds of torts]."

> States, if a private person, would be liable to the claimant in accordance with the law of the place where the act or omission occurred." (Emphasis supplied.)

Victoria's argument is that a claim for subordination of creditors is not a claim for "money damages" and is therefore not barred by the Tort Claims Act.

Our responses to this are:

1. A claim which seeks to subordinate the claims of one creditor to those of another is in effect a claim for "money damages;" and
2. The Federal Tort Claims Act by § 2680(a) and (h) precludes not merely claims for money damages but *any claims*.

1. A Claim for Subordination Is a Claim for Money Damages

In the present case, Victoria seeks to subordinate the claims of FDIC to its own claim. Such a form of relief is in effect the same as a claim for compensatory damages. It increases the money which Victoria will get from the Bank's estate, and reduces the money which FDIC will recover. It is out-of-pocket loss to one party and in-pocket gain to the other. In other words, though as far as the form of its claim goes, Victoria is seeking subordination of claims of a creditor, in fact it is trying to get money for alleged torts. In view of this identity in effect between a simple money judgment and the monetary result of subordination, we submit that subordination should be treated as a claim for "money damages" within the prohibitive sections of the Federal Tort Claims Act.

2. **The Federal Tort Claims Act Precludes Any Claim Arising out of Misrepresentation Or Out of Discretionary Acts, Not Merely Claims for Money Damages**

The section of the Tort Claims Act which prohibits certain actions is Section 2680.[40] The prohibitions in it against claims based on discretionary functions and

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[40]Section 2680 is as follows:

"The provisions of this chapter and section 1346(b) of this title shall not apply to—

(a) Any claim based upon an act or omission of an employee of the Government, exercising due care, in the execution of a statute or regulation, whether or not such statute or regulation be valid, or based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a federal agency or an employee of the Government, whether or not the discretion involved be abused.

(b) Any claim arising out of the loss, miscarriage, or negligent transmission of letters or postal matter.

(c) Any claim arising in respect of the assessment or collection of any tax or customs duty, or the detention of any goods or merchandise by any officer of customs or excise or any other law-enforcement officer.

(d) Any claim for which a remedy is provided by sections 741-752, 781-790 of Title 46, relating to claims or suits in admiralty against the United States.

(e) Any claim arising out of an act or omission of any employee of the Government in administering the provisions of sections 1-31 of Title 50, Appendix.

(f) Any claim for damages caused by the imposition or establishment of a quarantine by the United States.

(g) Repealed.

(h) Any claim arising out of assault, battery, false imprisonment, false arrest, malicious prosecution, abuse of process, libel, slander, misrepresentation, deceit, or interference with contract rights.

(i) Any claim for damages caused by the fiscal operations of the Treasury or by the regulation of the monetary system.

(j) Any claim arising out of the combatant activities of the military or naval forces, or the Coast Guard, during time of war.

(k) Any claim arising in a foreign country.

(l) Any claim arising from the activities of the Tennessee Valley Authority.

(m) Any claim arising from the activities of the Panama Canal Company.

(n) Any claim arising from the activities of a Federal land bank, a Federal intermediate credit bank, or a bank for cooperatives."

those arising out of misrepresentation or deceit are not limited to claims for money damages. They expressly include "any claim." Thus the section provides:

> "The provisions of this chapter and section 1346(b) of this title shall not apply to—
>
> "(a) *Any claim* . . . based upon the exercise . . . or the failure to exercise . . . a discretionary function . . .
>
> *　*　*　*　*　*　*
>
> "(h) *Any claim* arising out of . . . misrepresentation, deceit . . ." (Emphasis supplied.)

Furthermore, in all the subdivisions of § 2680 except (f) and (i) the prohibition is against "Any claim," whereas under subdivisions (f) and (i) "Any claim *for damages*" is prohibited. (Emphasis supplied.)

If Congress had intended that the Tort Claims Act should be limited in all respects to claims for money damages, there would have been no reason for including the phrase "for damages" in respect of the causes of action described in subdivisions (f) and (i); and to interpret the statute otherwise would be to disregard this statutory differentiation. This would violate the rule that words of a statute should never be considered surplusage if a reasonable construction can be adopted which will give force to and preserve all the terms of the statute.

> *Application of Rogers,* 229 F.2d 754 (9th Cir. 1956);
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> *England v. Moore Equipment Co.,* 94 F.Supp. 532 (N.D.Cal. 1950).

II

APART FROM THE TORT CLAIMS ACT, FDIC IS NOT LIABLE FOR THE DISCRETIONARY ACTIONS OF ITS OFFICERS PERFORMED WITHIN THE SCOPE OF THEIR GOVERNMENTAL AUTHORITY

Even if it were to be held that the Federal Tort Claims Act is inapplicable because a claim for subordination is not a claim for "money damages," appellant is still precluded from maintaining the present action for subordination against FDIC because of the principle that the performance by executive officers of discretionary governmental duties entrusted to them by statute is not subject to judicial review. *Pacific Nat. Fire Ins. Co. v. Tennessee Valley Authority,* 89 F.Supp. 978 (W.D.Va. 1950); *Atchley v. Tennessee Valley Authority,* 69 F.Supp. 952 (N.D.Ala. 1947); *Grant v. Tennessee Valley Authority,* 49 F. Supp. 564 (E.D.Tenn. 1942); *Adams v. Home Owners Loan Corporation,* 107 F.2d 139 (8th Cir. 1939).

In *Atchley v. Tennessee Valley Authority,* supra, plaintiff alleged that while defendant corporation was exercising powers committed to it by Congress by operating a system of dams and reservoirs to control flood waters, defendant negligently raised the waters in a certain reservoir until they overflowed and ruined plaintiff's crops. In a second count, plaintiff alleged that the action was done wilfully. The court held that the claim did not state a cause of action against the corporation, even though it consented to suit, stating (p. 955):

> "The present case comes clearly within the principle that the performance by executive officers

> of discretionary governmental duties entrusted to them by statute is not subject to judicial review. This principle has been reiterated time and again in mandamus proceedings to compel executive action, in injunction suits to prevent executive action, and in actions such as that at bar for damages claimed to have resulted from executive action."

In *Pacific Nat. Fire Ins. Co. v. Tennessee Valley Authority,* supra, suit was brought against the Authority for damage to property resulting from a blast of explosives set off by defendant. The court held that the action did not lie. It said (p. 979):

> "Although plaintiff alleges negligence in general terms, the sum and substance of its complaint is that defendant set off so large an explosion that it knew, or should have known, that damage to the Miller residence might result therefrom. Defendant is a Government agency, but it is provided by law that the corporation 'may sue and be sued in its corporate name'. Section 4(b) of the Tennessee Valley Authority Act, 16 U.S.C.A. § 831c(b). Defendant, by counsel, admits that, in certain instances, it would be liable for negligent acts of its agents. It contends, however, that in this instance the act complained of was done in the performance of a discretionary governmental duty entrusted to it by statute. There can be no question that the construction of the South Holston Dam was authorized by statute, and that the method of its erection was entrusted to the defendant. I agree with defendant that the setting off of the explosion described herein was in the performance of a discretionary gov-

> ernmental duty. Therefore, even if defendant was guilty of an abuse of discretion, it would not be liable for damages resulting therefrom. The principle seems well settled that the performance by executive officers of discretionary governmental duties entrusted to them by statute, is not subject to judicial review. (Citations)"

12 U.S.C. § 1819 provides that FDIC may "sue and be sued . . . in any court of law . . . state or federal," but it is held that such a statute does not nullify the principle above mentioned, that a governmental agency is not subject to suit for its discretionary acts. This appears in the *Pacific Nat. Fire Ins. Co.* case, as above shown, and also in the *Atchley* case, wherein the court said (pp. 953-954):

> "The plaintiffs here rely, just as did the plaintiffs in the Grant case, on the provision in section 4(b) of the Tennessee Valley Authority Act, 16 U.S.C.A. § 831c(b), that the corporation 'may sue and be sued in its corporate name.' In support of their position, plaintiffs cite the following cases: (citations) In my opinion, these cases do not sustain the plaintiffs' position. A distinction must be recognized between the procedural question of whether a government corporation is subject to suit and the substantive question of whether a given set of facts establishes its liability as a matter of substantive law. The sue-and-be-sued clause in the TVA Act does nothing but remove the procedural bar to suit against an agency of the federal government. It does not engender liability in a case where liability would not otherwise exist."

The principle was also recognized by the court in *Grant v. Tennessee Valley Authority,* wherein the court said (p. 565):

> "From this quotation and a review of the whole opinion, I am impressed with the idea that the inclusion of 'the conventional to-sue-and-to-be-sued clause' in the Tennessee Valley Authority Act is not a shibboleth to engender liability generally, but is to be taken into consideration with the congressional purposes in creating this governmental corporation."

The acts which Victoria alleges were committed by FDIC come clearly within the doctrine of the above cases. Such acts if committed would have been a part of the governmental functions imposed upon FDIC by statute and they would have been manifestly discretionary in character. *Dalehite v. United States,* above. For these reasons, independently of the Tort Claims Act, the action is barred.

VICTORIA'S REFERENCE TO PROCEEDING NO. 43512

A receiver of a national bank is required by 12 U.S.C. §192 [41] to get court approval of sales or compromises arising out of the liquidation of the bank.

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[41] The pertinent portion of the section is this:

> ". . . Such receiver, under the direction of the comptroller, shall take possession of the books, records, and assets of every description of such association, collect all debts, dues, and claims belonging to it, and, *upon the order of a court of record* of competent jurisdiction, may *sell or compound* all bad or doubtful debts, and, on a like order, may *sell all the real and personal property* of such association, on such terms as the court shall direct. . . ." (Emphasis supplied.)

FDIC, in connection with its liquidation of Bank, has, from time to time, petitioned the district court for such approvals. These petitions[42] were each entitled "In the Matter of the Liquidation of San Francisco National Bank" and each was given the same civil action number—43512—by the clerk of the district court. The petitions filed by FDIC did not and could not give to the district court a general power of supervision over the liquidation of the Bank, nor did they or could they provide a forum for the adjudication of claims against the Bank's estate. They were merely the vehicle which FDIC utilized to secure the court approval required by 12 U.S.C. § 192 for sales and compromises. In between court approval of one petition and the filing of the next, there was nothing pending before the U. S. District Court. The conclusion here expressed is supported by the decisions of this Court in *Fifer v. Williams,* 5 F.2d 286 (9th Cir. 1925) and in *Gockstetter v. Williams,* 9 F.2d 354 (9th Cir. 1925).

Judge Mathes in his orders of May 25 stated that his ruling was without prejudice to the right of plaintiff and cross-claimants to seek intervention in proceeding No. 43512. Thereafter, Victoria and the other appellants herein filed petitions to intervene in that Matter, which petitions were denied by Judge Wollenberg.[43]

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[42]Tr., 1-5; 167-173; 301-339 in No. 21258 now pending in this Court.

[43]Tr., 151-152 in No. 21258 now pending in this Court.

As a result of Judge Mathes' and Judge Wollenberg's orders, Victoria in its opening brief herein contends that "it is inequitable for FDIC to argue in both this case and in the liquidation proceeding that the claims of these appellants should be dismissed, and in effect, that they, therefore, have no legal remedy in federal courts."

This appears to say that FDIC is arguing that Victoria has no right to a hearing either in this case or in No. 43512. FDIC makes no such argument. On the contrary, FDIC says that the proceedings for the adjudication of Victoria's rights is a plenary suit, which the present suit is, and FDIC's contention is that in this suit Victoria has failed to state a claim upon which relief can be granted.[44]

---

[44]Victoria and the other appellants herein have appealed from the order of Judge Wollenberg denying their petitions to intervene in proceeding No. 43512. Those appeals are now pending before this Honorable Court, where they are numbered 21258 A-C. In their opening briefs in those appeals, appellants contend that if the present plenary suit is not the proper forum for the adjudication of their claims, they are entitled to get such adjudication in proceeding No. 43512. In our brief in No. 21258 we will respond to the latter point, and we will there present the reasons why No. 43512 is in no sense a forum for the adjudication of such claims, but that such claims must be adjudicated in a plenary suit.

Appeal of
Security Savings and Loan Association

Security has adopted the brief of Telephone Company. The facts in relation to Security are the same as those of Telephone Company, except that it renewed six $100,000 certificates of deposit totalling $600,000 and it did so on October 20, 1964. Its pleading[45] with regard to insolvency and subordination and the relief sought is substantally the same as Telephone Company's.

We therefore rely upon the contentions above asserted with respect to this appellant.

[45]Tr., 191-208.

CONCLUSION

Telephone Company is not entitled to a constructive trust, because the Bank was not hopelessly and irretrievably insolvent, and even if it were, the renewal of a deposit is not ground for such a trust because it does not augment the assets of the Bank.

Telephone Company is not entitled to subordination of claims of other creditors, because (a) such a claim would amount to a private action to enforce a government regulation, which is not permitted; (b) even if such an action were not thus prohibited, such subordination would be inequitable; and (c) in any event, FDIC should not be thus penalized, because it became a creditor by virtue of having paid insurance under a mandatory provision of the law.

Victoria's claim for constructive trust is barred for the same reason as that of Telephone Company.

Victoria's claim for subordination is barred (a) by the Tort Claims Act, in that suits coming under that Act must be brought against the United States rather than a federal agency; and even if it were brought against the United States, it would be barred by section 2680(h) of the Act because it is a claim for misrepresentation or deceit and it would also be barred by 2680(a) of the Act because it is a claim based upon the exercise of a discretionary function by a federal agency, and (b) even apart from the Tort Claims Act the suit is barred by the principle that performance by executive officers of discretionary governmental duties entrusted to them by statute is not subject to judicial review.

The claim of Security is barred for the same reasons as that of Telephone Company.

It is respectfully submitted, therefore, that the orders of the trial court should be affirmed.

Dated, San Francisco, California,
May 17, 1967.

Respectfully submitted,
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Certificate of Counsel

I certify that, in connection with the preparatio of this brief, I have examined Rules 18, 19 and 39 the United States Court of Appeals for the Nint Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Harold R. McKinnon,
Attorney for Said Appellees.

No. 21,165

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

AMERICAN TELEPHONE AND TELEGRAPH COMPANY, SECURITY SAVINGS AND LOAN ASSOCIATION AND VICTORIA SAVINGS AND LOAN ASSOCIATION,

Appellants,

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION, etc., *et al.,*

Appellees.

REPLY BRIEF OF APPELLANT VICTORIA SAVINGS AND LOAN ASSOCIATION.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

No. 21,165

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

American Telephone and Telegraph Company, Security Savings and Loan Association and Victoria Savings and Loan Association,

Appellants,

vs.

Federal Deposit Insurance Corporation, etc., *et al.,*

Appellees.

REPLY BRIEF OF APPELLANT VICTORIA SAVINGS AND LOAN ASSOCIATION.

Preliminary Statement.

This reply brief is in response to the brief of appellee Federal Deposit Insurance Corporation (hereinafter called "FDIC") and the brief of appellees A.M.R., Inc., *et al.*

The brief of appellee FDIC is divided into a section on the appeal of AT&T (pp. 7-23) and a section on the appeal of Victoria as to the claim raised by Victoria in its sixth cause of action which is not included in the complaint of AT&T (pp. 24-37).

As a reply to the brief of appellee FDIC on the appeal of AT&T, Victoria adopts and incorporates in full the reply brief of AT&T filed herein on or about June 7, 1967, since the position of Victoria with re-

gard to the applicable law and the essential facts is substantially identical to that of AT&T with the exception of certain factual differences as stated in Victoria's opening brief filed herein. In addition Victoria will herein expand and supplement briefly the argument made by AT&T in its reply brief. Victoria herein will also respond to the sections of the brief of appellee FDIC directed to the appeal of Victoria.

I.

A Motion to Dismiss a Complaint, Counterclaim or Cross-Claim Should Not Be Granted Without Permission to Amend Unless It Is Certain That the Complainant Would Not Be Entitled to Relief Under Any State of Facts Which Could Be Proved in Support of His Claim.

Appellee FDIC seeks to justify the dismissal of the complaint, counterclaims and cross-claims in this matter insofar as the causes of action impose a constructive trust on the ground that there is failure to allege that the San Francisco National Bank (hereinafter referred to as "BANK") was hopelessly and irretrievably insolvent (Appellee FDIC Br. pp. 8-11). Appellant Victoria in its cross-claim and counterclaim alleged that Bank was insolvent on the date that the certificate of deposit and the cashier's check which formed the basis of the claim of Victoria herein were issued to it [R. 24]. AT&T alleged in its complaint that Bank at the time its certificates of deposit were issued was either insolvent or in imminent danger of becoming insolvent [R. 6].

Victoria's position is that an allegation of "hopeless and irretrievable insolvency" is not necessary to state a cause of action for a constructive trust and rescis-

sion. Secondly, this is a factual question and can be proved under the allegation it made of Bank's insolvency. Third, if it is necessary to so allege, Victoria should be permitted to amend to so comply. It is of the utmost importance that the Appellate Court fully understand the circumstances concerning the dismissals from which orders therefor these appeals are taken.

Judge Mathes, on his own motion and without notice to any of the parties to this action, and without hearing or affording any of the parties a chance to brief the law on the subject, suddenly dismissed the action excepting as against FDIC [R. 90]. The appellants then made motions to vacate said order [R. 95, 112, 423] and FDIC countered with a motion to dismiss the remaining portions of the complaint and crossclaims against FDIC [R. 126], in which it did not raise in its memorandum the sufficiency of the allegations *re* insolvency and Judge Mathes denied, once again without hearing, the motions to vacate [R. 157] and granted the motion to dismiss [R. 55] but indicated in these orders that the reason he was dismissing the action, including the crossclaims, was not on any of the bases set forth in the brief of appellee FDIC, but because he believed that these claims should be brought by intervention in the Liquidation proceedings, Case #43512 then pending in the District Court [R. 155 and 157]. Thus there was no provision in the order permitting amendment, or any indication that the Judge had considered this highly technical point now raised by appellee FDIC.

As stated in AT&T's reply brief, at page 2, an allegation of hopeless and irretrievable insolvency is unnecessary to sustain an action for rescission or imposition

of a constructive trust. The degree of insolvency is a question of fact which it is submitted appellant Victoria is entitled to have tried under its allegation that Bank was insolvent. If the court feels that the words "hopeless and irretrievable" are necessary before the word "insolvent" it is submitted that appellant Victoria should be granted permission to amend its complaint to add these words.

It has long been the rule of this court that a motion to dismiss a complaint will not be granted without permission to amend unless it appears to a certainty that the plaintiff would not be entitled to relief under any state of facts which could be proved in support of the claim.

> *Sidebotham v. Robison* (9th Cir. 1954), 216 F. 2d 816, 823;
>
> *Bonanno v. Thomas* (9th Cir. 1962), 309 F. 2d 320;
>
> *Tipton v. Bearl Sprott* (9th Cir. 1949), 175 F. 2d 432;
>
> *Topping v. Fry* (7th Cir. 1945), 147 F. 2d 715, 718.

Though the granting of a motion to dismiss a complaint may be good as to a particular complaint leave to amend should be granted where existence of facts which, if alleged, would cure defects in the complaint, is shown, though no request to amend the pleadings is made to the court.

> *Bonanno v. Thomas, supra;*
>
> *Sidebotham v. Robison, supra.*

The existence of some of the facts to show such hopeless and irretrievable insolvency is shown on page 3

of the reply brief of AT&T and, in the interest of brevity, will not be repeated here.

It is not conceivable that Judge Mathes, in his orders dismissing the complaint, counterclaims and cross-claims, other than as against FDIC, and on his own motion without notice or hearing [R. 90], or in his order refusing the motions of AT&T and appellant Victoria to vacate said order [R. 157], or in his order dismissing the action as against FDIC on the motion of FDIC [R. 155] was doing so on the ground urged by FDIC in its appellee's brief, to wit, the failure to properly allege insolvency, or on the basis of the Federal Torts Claims Act. A consideration of these orders indicates that Judge Mathes dismissed these claims without prejudice and on the theory that in his opinion they should have been brought by intervention in the liquidation proceedings under Federal Rule of Civil Procedure 24, in Civil Action #43512, In the Matter of the Liquidation of the San Francisco National Bank [R. 155, 157].

Appellants herein followed the suggestions contained in the orders of Judge Mathes by presenting petitions to intervene in said liquidation proceedings, and were immediately met with motions to dismiss of appellees FDIC, on the ground that said proceeding was not the proper proceeding in which appellants could bring their claims. Unfortunately for appellants, the liquidation proceeding was handled by another judge, who had a different opinion than Judge Mathes had on whether the claims of appellants should be brought in the liquidation proceeding or in a plenary suit and the effect of the difference of opinion of these two learned judges was to deprive appellants of a forum to litigate

their claims and to amend the complaint if there were any necessary allegations left out. Judge Wollenberg dismissed the petitions of appellants herein, which order is the subject of the appeal pending in this court, case #21258C.

Despite the claims of FDIC to the contrary contained in its brief herein (p. 37) the effect of the action of FDIC in moving to dismiss in both this case and in case #43512, is to deny the appellants a hearing on the merits of their claims in either the liquidation proceeding or in a plenary suit, and in its brief on the technical ground that appellants have not sufficiently pleaded hopeless insolvency, a ground on which the lower court did not grant the dismissal, or apparently even considered.

II.

Victoria's Claim for Subordination of FDIC Is Not an Action Barred by the Federal Tort Claims Act.

Excepting for certain factual differences set forth in Victoria's opening brief filed herein, and excepting for Victoria's sixth count of its cross-claim which is directed against appellee FDIC, Victoria's cross-claims are identical to those of appellant AT&T. Victoria, in the sixth count of its cross-claim, which is directed against appellee FDIC, seeks to have the claim of FDIC against Bank subordinated to the claim of Victoria by reason of certain wrongful and inequitable acts of said FDIC and other participating federal agencies [R. 30-34]. By making this claim against FDIC, Victoria is not seeking a claim for money damages, but rather is invoking the equitable jurisdiction of the court to have the claim of another claimant in Bank, to wit,

FDIC, because of certain wrongful acts of said claimant, subordinated to the claim of Victoria.

Appellee FDIC in its brief (pp. 22-23) states that Victoria's cause of action for subordination is not a proper cause of action because of the provisions of the Federal Tort Claims Act and, in particular, sections 28 U.S.C. 2680(a)(h) and, secondly, because the acts complained of involve discretionary governmental duties.

Appellee FDIC in its brief does not cite any case in which a court has held that an equitable type of claim and relief requesting subordination and the imposition of a constructive trust rather than a money judgment was a claim under the Federal Tort Claims Act and, therefore, subject to the provisions of said Act, to wit, that it must be brought against the United States and, further, that it would be barred by Sections 28 U.S.C. 2680(a) and 2680(h), to wit discretionary acts and claims founded on misrepresentation or deceit.

The only case which appellants have been able to find in point confirms the position of appellants that the Federal Tort Claims Act is limited to an action for money damages and does not prohibit an action against a federal agency for equitable relief. This is the case of *B. C. Morton International Corporation v. FDIC* (1st Cir. 1962), 305 F. 2d 692, which involved an action against FDIC for a declaratory judgment and injunctive relief on the ground that the officials at FDIC had been guilty of misrepresentation. The District Court dismissed the action but the First Circuit reversed, vacating the judgment of the District Court and stating in footnote 2 on page 695 as follows:

> "The exclusive remedy provision of the Federal Tort Claims Act (28 U.S.C. §2679(a)) does not

bar this action since it is not an action for money damages cognizable under 28 U.S.C. §1346(b). See the text of 28 U.S.C. §§2679(a) and 1346(b); 2 Harper & James, Torts §29.12 (1956)."

The distinction between a suit for monetary damages and a suit for injunctive or other equitable relief which is permitted under the theory of *B. C. Morton International v. FDIC supra* was clearly pointed out by the court in the case of *Freeling v. Federal Deposit Insurance Corporation,* 221 F. Supp. 955 (W.D. Okla. 1962), aff'd per curiam, 326 F. 2d 971 (10th Cir. 1963) cited by appellee in its brief filed herein at page 25. The *Freeling* case involved an action for damages for slanderous statements alleged to have been made by officials of FDIC and the court distinguished on page 957 *B. C. Morton International Corporation v. FDIC supra* case on the ground that said action, even though it was based upon certain alleged misrepresentations, sought a remedy of declaratory relief and injunctive relief and, therefore, was properly maintainable against FDIC as contrasted with the action seeking monetary damages for slander, which came under the exclusive remedy of the Federal Tort Claims Act and could not be maintained due to the limitations of Section 2680(h) Title U.S.C. prohibiting an action for slander.

The Supreme Court has recognized that in the distribution of assets of an insolvent national bank equitable principles govern, and that priorities may be granted where the facts justify the same irrespective of the ratable distribution provisions of the statute.

Scott v. Armstrong (1892), 146 U.S. 499;

American Surety Co. v. Bethlehem National Bank (1941), 314 U.S. 314, 86 L. Ed. 241.

Victoria in seeking to have the claim of FDIC in the liquidation of Bank subordinated to the claim of Victoria is doing so on the basis of equitable principles and, in addition, is seeking an equitable remedy, to wit, subordination rather than a claim for money damages. Appellee FDIC's failure to recognize this distinction in remedy is the fallacy of the arguments made by FDIC in its brief, both as to the applicability of the Federal Tort Claims Act and as to the non-liability of FDIC for discretionary acts of its officers. In connection with the latter theory which is discussed on pages 32-35 of appellee FDIC's brief, the cases cited are those seeking damages against a governmental agency rather than seeking to apply equitable principles such as the doctrine of subordination of a claimant in the liquidation of a bank due to certain non-equitable activities on the part of said claimant.

Pacific National Fire Insurance Co. v. Tennessee Valley Authority (W.D. Va. 1950), 89 F. Supp. 978, *Atchley v. Tennesee Valley Authority* (N.D. Ala. 1947), 69 F. Supp. 972, and *Grant v. Tennessee Valley Authority* (E.D. Tenn. 1942), 49 F. Supp. 564 all involved claims for damages against Tennessee Valley Authority to property allegedly due to acts of Tennesee Valley Authority, and the case of *Adams v. Homeowners Loan Corp.* (8th Cir. 1939), 107 F. 2d 139 involved a claim for damages due to malicious prosecution. Not only is each of these cases a case seeking a monetary judgment and, therefore, not applicable to Victoria's request for subordination of the FDIC claim and to impose a constructive trust thereon on equitable principles, but also in the *Grant* and *Adams* cases judgment for the defendant was on the grounds of public

policy, and in the *Pacific National Fire Insurance Co.* case the judgment for the defendant, in addition to the ground of a discretionary act, was also on the ground that the damage was so incidental and consequential in character that it was non-compensable.

Title 12 U.S.C. 1819 permits a suit to be maintained against the Federal Deposit Insurance Corporation. It is only "civil actions on claims against the United States, for money damages" 28 U.S.C. 1346(b) that come under the exclusive remedy provisions of the Federal Tort Claims Act 28 U.S.C. 2679(a). Since this is not an action for money damages the "sue and be sued" provisions of 12 U.S.C. 1819 permit this action to be maintained against FDIC.

Conclusion.

Appellee FDIC does not seek to have the orders of dismissal appealed from herein affirmed on the grounds indicated by Judge Mathes in his order, to wit, that these claims should be brought in the liquidation proceeding, since FDIC opposed said procedure in the liquidation proceeding, but rather on the technical grounds that the appellants had not pleaded insolvency of Bank sufficiently to impose a constructive trust on its assets and without a case in point on the ground that an action seeking to subordinate the claim of FDIC was a claim barred under the Federal Tort Claims Act. Victoria requests this court to resolve the procedural differences as to the proper forum for appellants to bring their claims between the views of Judge Mathes and those of Judge Wollenberg, and to permit appellants to have their day in court on the merits of their respective claims.

For the foregoing reason we respectfully submit that this court should reverse the orders dismissing this action, including the counterclaims and cross-claims of appellant Victoria, and that said appellant be permitted to proceed to trial on the merits of its claim.

Respectfully submitted,

Hahn & Hahn,
David K. Robinson,
By David K. Robinson,
Attorneys for Appellant Victoria Savings and Loan Association.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing brief is in full compliance with those rules.

David K. Robinson

No. 21,165

IN THE

United States Court of Appeals

For the Ninth Circuit

American Telephone and Telegraph Company, Security Savings and Loan Association and Victoria Savings and Loan Association,

Appellants,

vs.

Federal Deposit Insurance Corporation, etc., et al.,

Appellees.

REPLY BRIEF OF APPELLANT AMERICAN TELEPHONE AND TELEGRAPH COMPANY

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Table of Contents

Table of Authorities Cited

Cases

Rules

Regulations

Statutes

Other Authorities

No. 21,165

IN THE

United States Court of Appeals

For the Ninth Circuit

AMERICAN TELEPHONE AND TELEGRAPH COMPANY, SECURITY SAVINGS AND LOAN ASSOCIATION and VICTORIA SAVINGS AND LOAN ASSOCIATION,

Appellants,

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION, etc., et al.,

Appellees.

REPLY BRIEF OF APPELLANT AMERICAN TELEPHONE AND TELEGRAPH COMPANY

PRELIMINARY STATEMENT

This reply brief is in response to the brief of appellee Federal Deposit Insurance Corporation (hereinafter called "FDIC") and the brief of appellees A.M.R., Inc., et al.

ARGUMENT

I. THE COMPLAINT STATES FACTS WHICH ENTITLE APPELLANT TO RESCISSION AND TO A CONSTRUCTIVE TRUST.

In our opening brief, we pointed out that appellant is entitled to rescission of its deposit or to the imposition

of a constructive trust on the assets of the Bank because of fraud of the Bank in accepting the renewal of appellant's deposit (Opening Brief, pp. 7-12). The complaint alleged that the Bank was known by its officers to be insolvent or in imminent danger of becoming insolvent and concealed that fact from appellant when it accepted renewal (R. 6). It also concealed the fact that it was paying illegal bounties to other depositors and that its officers were engaged in other illegal activities which imperiled its financial stability (R. 6).

Appellee FDIC seeks to support the dismissal of the action insofar as it involved a constructive trust or rescission on two grounds: (a) The complaint did not allege that the insolvency was "hopeless" or "irretrievable" (Brief of Appellee FDIC, pp. 8-11); and (b) the renewal of the deposit did not augment the assets of the Bank (Brief of Appellee FDIC, pp. 11-14). As we will show, there is no merit to either contention.

A. The complaint contains sufficient allegations of the insolvency of the Bank at the time it accepted the renewal of appellant's deposit.

A bank's insolvency at the time it accepts a deposit is grounds for rescission or imposition of a constructive trust. Contrary to FDIC's brief (Brief of Appellee FDIC, pp. 8-11), an allegation of "hopeless and irretrievable" insolvency is unnecessary.

Some cases, as cited by FDIC, do from time to time employ the "hopeless and irretrievable" rubric; other cases, however, speak only in terms of "insolvency," e.g., *Mechanics Co. v. Culhane* (1936) 299 U.S. 51, 57-58;

Richardson v. Olivier (5 Cir. 1900) 105 Fed. 277, 277-278; *Cronkleton v. Ebmeier* (8 Cir. 1930) 38 F.2d 748, 749-750.

The degree of insolvency existing at the time of deposit is a complex factual question not capable of determination by applying the oversimplified labels FDIC suggests to the Court. If such labels are essential to state a claim, appellant is entitled to amend its complaint. The conclusion of the Comptroller of the Currency that, by May of 1964 (8 months before the transaction in question), the Bank was "so murked down in rot and corruption that there was *no hope*"[1] affords ample basis for such an amendment.

Appellees A.M.R., Inc., et al., suggest that since the Bank was insolvent at the time it accepted the renewal of appellant's deposit, the repayment of the deposit would have constituted an unlawful preference (Brief of Appellees A.M.R., Inc., et al., p. 12). This line of argument has been flatly rejected by the Supreme Court (*McDonald, Receiver v. Chemical Nat'l Bank* (1899) 174 U.S. 610, 618; see also *Mechanics Co. v. Culhane* (1936) 299 U.S. 51, 56).

Apart from a bank's insolvency, a depositor is entitled to a constructive trust when other circumstances render it wrong or contrary to law or good conscience for the bank to accept his deposit (*Tucker v. Newcomb* (4 Cir. 1933) 67 F.2d 177, 179). Appellant contends that the Bank's solicitation and acceptance of the renewal of appel-

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[1]Quoted in Interim Report of Committee on Governmental Operations (U.S. Senate, 89th Cong., 2d Sess.), p. 40; emphasis added.

lant's deposit was wrongful, because the Bank concealed its perilous financial condition, the payment of illegal bounties to other depositors, and other illegal activities of its officers imperiling its financial stability (Opening Brief, pp. 8-9; see also R. 6).

Appellee FDIC cannot avoid the principle set forth in the *Tucker* case by the bald assertion that the *Tucker* case "is inapplicable factually" (Brief of Appellee FDIC, p. 15). Obviously, the circumstances which render an acceptance of a deposit wrongful will vary from case to case. Nor can FDIC avoid the *Tucker* principle by erroneously characterizing appellant's claim as resting solely on the Bank's insolvency (Brief of Appellee FDIC, p. 15).

B. Renewal of appellant's deposit augmented the assets of the Bank.

Appellee FDIC, by asserting (Brief of Appellee FDIC, p. 11) that appellant's renewal of deposit did not augment the assets of the Bank for purposes of a constructive trust, would require an actual, physical withdrawal and immediate redeposit of the funds on deposit in order for a depositor to preserve his rights. This ignores the fact that by the renewal of the deposit and the issuance of a new certificate of deposit the Bank obtained the right to use funds to which it otherwise would not be entitled. Also, it makes the result in any given case dependent on a totally unrealistic circumstance, i.e., whether the depositor was given physical possession of his deposit for a single instant at some stage in the renewal process.

Appellant has recognized that cases exist which reflect such a ritualistic approach to augmentation (Opening

Brief, p. 10). Cases cited by appellee FDIC (Brief of Appellee FDIC, p. 11) also reflect this approach but at the same time illustrate why it should not apply to this case. Both *Henneman v. Rosebud Bank* (Mo.App. 1935) 78 S.W. 2d 113 and *Barsness v. Tiegen* (1931) 184 Minn. 188, 238 N.W. 161 are based on erroneous legal assumptions. There the Missouri and Minnesota state courts erroneously assumed that an insolvent bank cannot lawfully repay deposits in the ordinary course of its business, and therefore those courts could not understand how, if the bank was insolvent at the time of the renewal, any augmentation could have occurred. Their assumption is directly contrary to the holding by the United States Supreme Court in *McDonald, Receiver v. Chemical Nat'l Bank* (1899) 174 U.S. 610, 618 (discussed above, p. 3).

Mallett v. Tunnicliffe (1931) 102 Fla. 809, 136 So. 346, *Venner v. Cox* (Tenn.Ch.App. 1895) 35 S.W. 769, and *Fagan v. Whidden* (5 Cir. 1932) 57 F.2d 631, did not involve renewals of deposits. In *Mallett* and *Venner,* the depositors intended to withdraw the funds in their bank accounts but were induced not to do so. In *Fagan,* the bank merely informed the depositor's executor that no deposit existed, thus enabling it to retain the depositor's savings account. These situations are fundamentally distinct from a depositor's renewal, at the express solicitation of the bank, of his deposit and the issuance of a new certificate of deposit issued for a specific length of time. In the cases cited by FDIC the banks maintained the status quo, but only until further demand by the depositors. In the case at bar, the renewal of the deposit and issuance of a new certificate of deposit gave the bank the

absolute right to the use of the funds for the additional term specified in the new certificate.

Luikart v. Schmidt (1940) 138 Neb. 282, 292 N.W. 723, is farther off the mark. The Nebraska Court was there concerned with enforcement of Nebraska's then existing statutory policy of shareholder liability in bank failures.

Allied Mills v. Horton (7 Cir. 1933) 65 F.2d 708, involved a mere breach of contract rather than fraud; also, the bank was not shown to have been insolvent at the time the check was deposited for collection (65 F.2d 711).

FDIC contends that appellant's cases, *Federal Reserve Bank v. Idaho Grimm Alfalfa Seed G. Ass'n* (9 Cir. 1925) 8 F.2d 922, 928, and *Am. Nat'l Bank v. Miller* (1913) 229 U.S. 517, 519-520, are inapplicable because they do not involve renewals of deposits (Brief of Appellee FDIC, pp. 15-16). FDIC ignores the substance of the transactions in those cases, which in economic effect were analogous to the renewal of a deposit.

Finally, FDIC's contentions as to augmentation are completely out of line with modern commercial practices. If its contentions are allowed to defeat appellant's claims, then bank depositors will in the future be required to engage in symbolic rituals (withdrawal and immediate redeposit) if they are to preserve their rights upon the renewal of a deposit and the issuance of a new certificate of deposit.

II. THE CLAIMS OF DEPOSITORS THAT RECEIVED ILLEGAL BOUNTIES SHOULD BE SUBORDINATED TO THE CLAIMS OF INNOCENT DEPOSITORS.

FDIC does not question that the bounties were illegal but asserts that appellant cannot rely upon that illegality to subordinate the claims of the bounty takers to those of the innocent depositors (Brief of Appellee FDIC, pp. 17-18). On the other hand, appellees A.M.R., Inc., et al.,[2] contend that the complaint does not show that the bounties were illegal (Brief of Appellees A.M.R., Inc., et al., pp. 13-20). Neither contention has merit.

FDIC apparently admits that payments received by depositors in the Bank in excess of the limits set by Regulation Q are illegal, but asserts (Brief of Appellee FDIC, p. 18) that no private cause of action accrues from such wrongdoing. Appellant however is not attempting to enforce Regulation Q against the Bank or against FDIC as its receiver. Appellant's claim involves only the rights of the creditors among themselves.

Blaney v. Florida National Bank at Orlando (5 Cir. 1966) 357 F.2d 27 (Brief of Appellee FDIC, p. 18) is inapplicable. In that case the plaintiffs, as holders of bonds issued under a trust indenture agreement, sued a national bank, as trustee, for violation of its fiduciary obligations. Plaintiffs attempted to state a Federal claim *against the bank* under a Federal Reserve regulation which requires a national bank to "conform to sound principles in the operation of its trust department" (357 F.2d 28). The court held that the plaintiffs could not sue

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[2]The reference by Appellees A.M.R., Inc., et al., to themselves as "the Majority Depositors," is without support in the record which does not show the aggregate amount of the claims against the Bank.

the bank under that regulation because the remedy *against the bank* for violations of the regulation belonged exclusively to the Board of Governors of the Federal Reserve System.

Appellant is not attempting to enforce Regulation Q against the Bank; rather appellant contends that the public policy against excessive interest payments expressed in Regulation Q and the equitable principles applicable to distribution of assets of an insolvent bank (Opening Brief, pp. 16-18) require subordination of the claims of the bounty-taking depositors.

Appellees A.M.R., Inc., et al., misstate appellant's complaint when they assert (Brief of Appellees A.M.R., Inc., et al., p. 3) it is based upon the depositor defendants' activities only in "link-financing" or "money-brokerage" transactions. On the contrary, the complaint alleges that the depositor defendants, "as compensation for making or renewing such deposits, and in addition to interest at legal rates * * * received directly or indirectly from Bank certain benefits, bounties or gratuities prohibited by law (hereinafter collectively called 'bounties')" (R. 4-5). Appellees' suggestion (Brief of Appellees A.M.R., Inc., et al., pp. 15-18) that they engaged only in assertedly lawful transactions is wholly unsupported by the record on this appeal, and cannot be maintained in the face of appellant's allegation of bounty taking, quoted above.

Appellees A.M.R., Inc., et al., assert (Brief of Appellees A.M.R., Inc., et al., p. 3) that the complaint is insufficient because it does not allege facts showing that taking bounties is illegal. The complaint meets the requirements of Rule 8(a) of the Federal Rules of Civil Procedure. It

alleges that the bounties received by these appellees were "prohibited by law" (R. 4-5), and that these bounties were "in addition to interest at legal rates" (R. 4).

In addition, FDIC argues that the equities require that the bounty takers be placed on the same footing as innocent depositors.[3] FDIC contends that if the bounty takers are subordinated, there would not be sufficient assets to pay any part of their claims (Brief of Appellee FDIC, p. 18). But there is no indication in the record that payment of the claims of the innocent depositors will exhaust the assets of the Bank or prevent a distribution to the bounty takers.

There is reason for subordinating the claims of the bounty takers. The facts controlling this appeal, alleged in appellant's complaint, are that "the payment of bounties contributed to the insolvency of Bank and to plaintiff's loss" (R. 9). It is noteworthy that FDIC informed the court below that bounty taking "contributed to the failure of San Francisco National Bank" (Closing Brief of FDIC in support of motion to dismiss in *A.M.R., Inc., et al. v. Federal Reserve Bank of San Francisco, et al.* (Civil Action No. 44387) p. 42; quoted, R. 142). This statement by FDIC was based largely on the findings contained in a report of the United States Senate Committee on Governmental Operations. That report states that "abuses asso-

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[3]FDIC, in its dual capacity as receiver of the Bank representing all creditors, and subrogee of the claims of the bounty-taking depositors to the extent it has paid them deposit insurance, is placed in the tenuous position of now defending the very practices which it previously attacked in ***F.D.I.C. v. A.M.R., Inc., et al.*** (U.S. District Court, N.D.Cal., Civil No. 43272). In that case, FDIC alleged that the receipt of bounties by depositors denied them the right to Federal deposit insurance.

ciated with certificates of deposit are principal factors in the chain of events that led to recent bank failures,'' and gives as an example ''San Francisco National Bank, which paid 7 percent for certain large amounts of funds obtained by certificates of deposit'' (Interim Report of Committee on Governmental Operations (U.S. Senate, 89th Cong., 2d Sess.) p. 6, see also ibid., pp. 8 and 31).

FDIC asserts (Brief of Appellee FDIC, p. 19) that if the claims of the bounty takers are subordinated, FDIC, as insurer and assignee of a portion of the bounty takers' claims, should be exempt from subordination. This assertion is unsupported by any authority, and ignores the fundamental principle that an assignee has no greater rights than his assignor (*Lount v. Mosher* (9 Cir. 1940) 115 F.2d 903, certiorari denied (1941) 313 U.S. 581). The same rule also applies where the assignee succeeds to the interest of the assignor under a contract of insurance (*Royal Indem. Co. v. Security Truck Lines* (1963) 212 Cal.App.2d 61, 65-66, 27 Cal.Rptr. 858, 860-861). This accords with section 11(g) of the Federal Deposit Insurance Act (64 Stat. 873, 885) which defines FDIC's subrogation rights as including the right ''to receive the same dividends from the proceeds of the assets of such closed bank * * * as would have been payable to the depositor * * *'' (64 Stat. 885; 12 U.S.C. 1821(g)).

CONCLUSION

For the foregoing reasons, we respectfully submit that this Court should reverse the orders dismissing the defendant depositors (which no appellee has attempted to support) and the order dismissing the action.

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Certificate of Counsel

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Noble K. Gregory,
Attorney for Appellant American Telephone and Telegraph Company.

No. 21,169

IN THE

United States Court of Appeals

For the Ninth Circuit

A. BATES BUTLER, Trustee of Construction Materials Co.,

Appellant,

vs.

PACIFIC NATIONAL INSURANCE COMPANY, aka TRANSAMERICA INSURANCE COMPANY, and STATE OF ARIZONA, DAVID H. CAMPBELL, Superintendent, Arizona Highway Department,

Appellees.

On Appeal from the United States District Court for the District of Arizona

OPENING BRIEF FOR APPELLANT

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Subject Index

Table of Authorities Cited

No. 21,169

IN THE

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Appellees.

On Appeal from the United States District Court for the District of Arizona

OPENING BRIEF FOR APPELLANT

JURISDICTIONAL STATEMENT

This is an appeal from a judgment entered on the 6th day of April, 1966, by the United States District Court for the District of Arizona. This appeal is brought under the jurisdiction established in Section 24 of the Bankruptcy Act, 11 U.S.C.A., Section 47.

INTRODUCTION

For the sake of clarity, A. Bates Butler, Trustee in Bankruptcy of Construction Materials Company, bankrupt, appellant, shall hereafter be referred to as "trustee". Construction Materials Company, bankrupt, will hereafter be referred to as "bankrupt". Transamerica Insurance Company shall hereafter be referred to as "appellee".

The appellant, after thorough research, has come to the conclusion that the only specification of error relied upon is as contained in this brief, and therefore, this brief will contain no questions or argument as to other specifications of errors previously filed herein.

STATEMENT OF THE CASE

The appellant in this case is the duly appointed and acting trustee in bankruptcy of the bankrupt. A Chapter XI Bankruptcy Proceeding (voluntary) was filed on November 22, 1963. At that time, the bankrupt was doing certain road work for the State of Arizona under a contract designated as U.S. 345 (4) East Broadway Road, Tucson (see appellant's Exhibit No. 2). Upon undertaking the contract, the bankrupt had furnished the State of Arizona a bond for performance of contract written by Pacific National Insurance Company as surety. (It is stipulated that Pacific National Insurance Company is the predecessor of appellee). The bankrupt commenced work in June of 1963 and at no time did the work cease

until final completion of the contract in November of 1963. The bankrupt entered into a written contract with Ashton Construction Co. (see appellant's Exhibit No. 4), whereby Ashton agreed to complete the project as a subcontractor of the bankrupt. Ashton was to bill the bankrupt for its work and the bankrupt was thereupon to pay Ashton. The State of Arizona was not a party to this contract and neither was appellee. There was no assignment of funds from the bankrupt to Ashton of any funds held by the State of Arizona. The Ashton Company finished its work during the month of December, 1963. At the time the work was completed the State of Arizona had received actual notice that the appellant had been appointed as receiver for the bankrupt. The Ashton Company billed the bankrupt for the sum of $33,238.60 on the subject project. The State of Arizona after deducting a charge for late completion still had in its possession the sum of $21,557.27 as funds due the contractor on said job. In March of 1964 Ashton in writing (see appellant's Exhibit No. 7), requested information from the State of Arizona pertaining to the performance bond posted by the bankrupt. After extended negotiations with appellee, Ashton settled its claim for $31,000.00 which was paid by appellee to Ashton, and Ashton assigned its claim to the funds held by the State of Arizona to the appellee on May 13, 1964 (see appellant's Exhibit No. 8). The State of Arizona made no claim to the money it held and interpleaded same with the District Court hearing the subject case to be held until final decision of the case.

SPECIFICATION OF ERROR RELIED UPON

Since appellee had no agreement with the bankrupt pertaining to an assignment of funds held by the State of Arizona, it cannot by its own act become a secured creditor with rights superior to other general or unsecured creditors of the bankrupt.

QUESTION PRESENTED

Is the appellee barred from receiving the money held by the State of Arizona when it did not have any assignment agreement with the bankrupt whereby the bankrupt assigned to the funds held for the bankrupt by the State of Arizona?

ARGUMENT

The law is well settled and to the contrary of the appellee's position that in the absence of a specific provision establishing it in the contract the surety has no direct right to funds held by the State, and neither does the sub-contractor or materialman. *Adamson v. Paonessa,* 179 Pac. 880.

The first point that must be established in order to decide who is entitled to the funds is what is the law of the State of Arizona on this point. The District Court will apply the law of the State of Arizona since the contract arose here and was completed here between residents of this State.

The law of Arizona pertaining to lien rights of contractors, sub-contractors and materialmen is set forth in Section 33-981, Arizona Revised Statutes, as amended:

> "Sec. 33-981. Lien for labor or materials used in construction, alteration or repair of structures.
>
> A. Every person who labors or furnishes materials, machinery, fixtures or tools in the construction, alteration or repair of any building, or other structure or improvement whatever, shall have a lien thereon for the work or labor done or materials, machinery, fixtures or tools furnished, whether the work was done or articles furnished at the instance of the owner of the building, structure or improvement, or his agent.
>
> B. Every contractor, sub-contractor, architect, builder or other person having charge or control of the construction, alteration or repair, either wholly or in part, of any building, structure or improvement, is the agent of the owner for the purposes of this article, and the owner shall be liable for the reasonable value of labor or materials furnished to his agent."

This law as it pertains to public contracts was the subject of the case of *Webb v. Crane Co.,* an Arizona case reported in 52 Ariz. 299, 80 P.2d 698. In that case, Webb entered into a contract with the Arizona State Teachers College at Flagstaff to do some construction work. Webb submitted two bonds in conjunction with the contract, one a performance bond and one a labor bond. Subsequently, a supplier who

was not paid by a sub-contractor who did the plumbing work, brought suit against Webb and his surety on the theory that the bond posted was a third party bond. The Court held for the Plaintiff and in the decision went into the question of lien rights in Arizona so far as public construction work was concerned. The Court quoted from the cases of *Storey & Fawcett v. Nampa and Meridian Serv. Dist.,* 32 Idaho 713, 187 Pac. 946, and *Hutchinson v. Krueger,* 34 Okla. 23, 124 Pac. 591 to the effect,

> "The general rule, supported not only by reason but by the overwhelming weight of authority, is that a mechanic's lien does not attach to public property unless expressly provided by statute, since such lien would be contrary to public policy and also incapable of enforcement."

Webb specifically took exception to this interpretation and said it was inapplicable in Arizona for the reason that the lien law referred to "any building". The Court held that that expression did not provide specifically and expressly that the mechanic's lien law shall apply to public buildings or property, but did so only inferentially, if at all, and then quoted from the case of *Moss Iron Works v. Jackson County Court,* 89 W. Va. 367, 109 S.E. 343, as follows:

> "Inclusion by reference or interpretation is not sufficient, when the right to perfect a mechanic's lien or materialman's lien upon public buildings is involved. To warrant the creation and enforcement of such a lien against public buildings, the authority must be specific, positive, and unmistakable in its meaning and terms. They must leave open no room for construction or interpre-

> tation. . . To subject property owned and used by the public for the transaction of public business to the mechanic's liens, the authorization must, according to the general, indeed the most invariable rule, be unequivocal, not inferential."

In the *Webb* case the Court established the law of the State of Arizona to be unequivocally "that public buildings used for public purposes are not subject to a mechanic's lien law unless the Legislature has expressly made them so".

The Legislature of the State of Arizona has not seen fit to subject contracts for public works to the mechanic's lien laws. It is therefore seen that the laborers or materialmen whom the appellee paid had no lien rights against the State. Any rights that the appellee got by subrogation are limited to the rights that they, the creditors, had. Just what rights did they have? They had no right against the State since the contract between the State and Construction Materials Company provided for no such right. There was no agreement whatsoever between the State and the appellee giving the appellee a right to retained funds in the event the appellee paid any claims under its bond.

In the case at hand no written application was made for the bond submitted to the State of Arizona and no verification or check of the financial standing of Construction Materials Company was made (see deposition of George Leacher, p. 14, line 13, through p. 17, line 26). There was no indemnity agreement between Construction Materials Co. and the appellee and one

had never existed. There is in fact no basis for the appellant's claim other than the Agreement of November, 1962, which was entered into between Construction Materials Co. and an entirely different and distinct insurance company. It is stretching the imagination to hope that such an indemnity agreement could give this appellee any rights whatsoever. There was and is no indemnity agreement in existence which would give the appellee in this case any right to retained funds held by the State of Arizona. The appellee knew prior to the time it paid out any funds that the State of Arizona would not pay any monies to them (see Exhibit No. 15), and yet with this knowledge, paid to Ashton the sum of $31,000.00 (see Depo. George Leacher, p. 8, line 15, through p. 9, line 18).

It is appellant's position that payment by a surety to sub-contractor for a claim filed by the sub-contractor gives the surety just whatever rights the sub-contractor had against the State (or to the retained funds), and no greater rights. This is the law and has been settled in the case of *Adamson v. Paonessa,* a California case reported in 179 Pac. 880. This case is almost exactly similar to the case at hand. Paonessa had entered into a contract to do certain work for the City of Colton. He filed a surety bond (for the payment of claims for materials, labor, etc.). National Surety Company was the surety on the bond. Paonessa had made a written application for the bond. (In the case at hand we have no such written application.) A portion of the application reads as follows:

> "All payments specified in the above-mentioned contract (i.e. the contract with the City of Colton for doing the work) to be withheld by the obligee until the completion of the work shall, as soon as the work is completed, be paid to the Company (the surety company) and this covenant shall operate as an assignment thereof, and the residue, if any, after reimbursing the company as aforesaid, be paid to the applicant after all liability of the Company has ceased to exist under said bond."

No notice of this assignment (if it was an assignment), was given to the City. (In our case no notice of the indemnity agreement in the name of another insurance company was given to the State until approximately one week before final completion of the job and until the day that Construction Materials Co. had filed a petition for relief under Chapter XI of the Bankruptcy Act.) While the work was in progress another Defendant, Lloyd, advanced funds to Paonessa and took a written assignment of all his rights under the contract and filed the assignment with the City Clerk. When the job was completed the City recognized the assignment to Lloyd. The surety then demanded the money (warrants) on the ground that they held an assignment by virtue of the bond application and the fact that they were called upon to pay approximately $10,000.00 for material and labor furnished which Paonessa had not paid. Judgment was entered against the surety company when then appealed and advanced two grounds for the appeal. Both of the grounds advanced are the grounds that

the appellee in this case suggests as the basis for its claim:

1. That by virtue of its payment as surety for Paonessa of claims against Paonessa for labor and material furnished, it acquired by subrogation an equitable lien upon any monies due under the contract superior to an assignment or other disposition that Paonessa might have made, and

2. That by virtue of the application for the bond, he, Paonessa, had assigned to the surety his right to the money (warrants) to become due him under the contract with the City and this assignment being prior in time to the assignments to Lloyd, is prior in right.

In answer to the first point the Court acknowledged that the surety by virtue of paying the claim pursuant to its obligation as surety obtained a subrogation in its favor of any rights which the claimant had whose claims were paid. But it was also true that the subrogation would give no greater rights than this. The Court then attempted to establish what rights these claimants would have had and decided that the claimants would have had no rights to the funds (warrants). The Court then differentiated between that case and *Prairie State National Bank v. U.S.*, 164 U.S. 227 (relied upon by the appellee in this case to substantiate its position). In explaining the difference the Court said:

> "In those decisions (Prairie State National Bank and others) the facts are essentially the same as

> in this, with the exception that either by statute or by the contract itself a fund was in effect reserved for the benefit of materialmen and laborers whom the contractor might fail to pay."

(In our case neither the contract nor any statute made such a provision.)

> "In other words, the materialmen and laborers had a right as against a certain fund in addition to any recovery against the contractor or his surety. Under such circumstances, if the surety paid their claims, he would be subrogated to their rights against such fund. Such, however, is not the case here, as there is no fund against which the materialmen and laborers have a right."

An examination of the contract in question (Exhibit No. 2), will show that in the case at hand there is no such fund either. Thus we see no statute providing for payment, no contract containing such a payment provision, and no fund out of which to make such payment. The claimant is limited to his right against the surety on the bond and the surety is subrogated to no greater right than the claimant whom he paid had.

The second point on appeal pertained to the notice of assignment given by the surety to the City. They had not given the City notice of the assignment as contained in the application for the bond and the Court held the City was not bound by it since they did have notice of the assignment to Lloyd. In our case there was no written application for the bond, no assignment to the appellee. The appellee is attempting

to become a third party beneficiary of an assignment to a completely autonomous insurance company. The American Insurance Company was a completely independent company authorized in its own name to conduct business in Arizona and was not an agent of the appellee company. American Insurance Company wrote insurance in its own name (see George Leacher deposition, p. 18, lines 11 through 16). It was a distinct corporate entity at the time it obtained the agreement and at the time of the contract between the State and Construction Materials Company in June, 1963. (See deposition of George Leacher, p. 20, lines 16 through 20.)

CONCLUSION

In view of the fact that appellee had notice that the State of Arizona would not pay any sums to them which they were holding without the express written consent of the appellant, and on the further fact that the appellee had no written assignment whatsoever of funds held by the State, it is submitted that appellee acted at its own risk in making payments to Ashton, and cannot by virtue of the fact of having made such payments become a secured creditor with priorities superior to other general creditors of the bankrupt.

It is respectfully submitted that the judgment of the District Court be reversed and that the funds held by the State of Arizona be paid to the appellant herein for disbursement upon order of the Referee

in Bankruptcy for the United States District Court for the District of Arizona.

Dated, Tucson, Arizona,
November 3, 1966.

Hirsch, Van Slyke & Ollason,
By Gerald B. Hirsch,
Attorneys for Appellant.

Certificate of Counsel

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Hirsch, Van Slyke & Ollason,
By Gerald B. Hirsch,
Attorneys for Appellant.

No. 21,169

In the

United States Court of Appeals

for the Ninth Circuit

A. BATES BUTLER, Trustee of CONSTRUCTION MATERIALS CO.,

Appellant,

vs.

PACIFIC NATIONAL INSURANCE COMPANY, nka TRANSAMERICA INSURANCE COMPANY,

Appellee.

On Appeal from the United States District Court for the District of Arizona

Answering Brief of Appellee

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TABLE OF CONTENTS

TABLE OF AUTHORITIES CITED

Cases

Statutes

No. 21,169

In the

United States Court of Appeals

for the Ninth Circuit

A. Bates Butler, Trustee of Construction Materials Co.,

Appellant,

vs.

Pacific National Insurance Company, nka Transamerica Insurance Company,

Appellee.

On Appeal from the United States District Court for the District of Arizona

Answering Brief of Appellee

PREFATORY NOTE

Throughout this brief, appellant is referred to as "Trustee;" Construction Materials Co. as "Construction;" The Ashton Company, Inc., as "Ashton;" State of Arizona as "State," and appellee as "Pacific."

Most of the ultimate facts in the trial court were undisputed, and were made part of the record by a written Stipulation filed January 7, 1966, which stipulation is designated as document No. 15 in the Clerk's Certificate to Record on Appeal, and begins at page 41 of the Transcript of Record on Appeal. It is cited hereinafter as "Stipulation."

JURISDICTIONAL STATEMENT

While Trustee invoked the jurisdiction of the United States District Court for the District of Arizona under the provisions of Title 11 USC Chapter 7, § 110 and amendments thereto, § 70 of the Bankruptcy Act (Complaint), the court found as a fact diversity of citizenship and that the amount in controversy exceeded the sum of $10,000.00, exclusive of interest and costs (Stipulation; Findings of Fact No. 1), basing its jurisdiction on Title 28 USC Chapter 85, § 1332. Jurisdiction of this court on appeal is asserted under Title 11 USC Chapter 4, § 47.

STATEMENT OF THE CASE

Pacific apprehends the undisputed facts germane to this appeal to be as follows:

Construction and State entered into a construction contract on or about July 28, 1963, which contract (Exhibit 2 in evidence) expressly included a surety bond (Exhibit 1 in evidence) executed by Construction as principal and Pacific as surety. One of the conditions of the bond portion of the contract was that Construction "shall promptly pay . . . all laborers, mechanics, subcontractors and material men . . ."

The bond was executed on behalf of Pacific by Sol Ahee; Ahee would not have done so in the absence of a certain General Agreement of Indemnity dated November 19, 1962 (Exhibit 19 in evidence). Nominal parties to the indemnity agreement were Construction and American Surety Company of New York, but Ahee had been informed by the bond superintendent for Transamerica Insurance Group that it was equally binding for Pacific which, like American Surety Company, was a member of the Transamerica Insurance Group (Stipulation, pages 45-46, Transcript of

Record on Appeal). Pertinent portions of the General Agreement of Indemnity provided as follows:

> "EIGHTH—That in the event any such bond be given in connection with a contract of the Indemnitor (Construction) for construction work . . . Indemnitor further agrees in the event of any breach or default on his part in any of the provisions of said contract and/or bond that the said Company, shall be subrogated to all the rights and properties of the Indemnitor in such contract, including deferred and reserved payments, current and earned estimates and final payments, and any and all moneys and securities that may be due and payable at the time of such default on said contract."
>
> "THIRTEENTH—That all the terms and conditions of this agreement shall stand for the protection of . . . any other surety procured by the American Surety Company of New York . . ."

Construction began work under the contract on or about July 8, 1963, and entered into a written agreement (Exhibit 4 in evidence) on or about November 1, 1963, for Ashton to complete the work as a subcontractor.

On November 22, 1963, by registered letter (Exhibit 10 in evidence), Harold S. Cole, claim manager for Transamerica Insurance Group, asked State not to release any funds remaining for disbursement under the contract to anyone other than Ashton or Pacific, in order to secure payment to Ashton, and enclosed a copy of the said General Agreement of Indemnity. The letter and copy of the indemnity agreement were acknowledged by State under date of November 26, 1963 (Exhibit 11 in evidence).

On or about November 22, 1963, Construction voluntarily filed a petition in the District Court of Arizona for relief under Chapter XI of the Bankruptcy Act. A receiver was appointed on November 26, 1963, and subsequent to the

latter date Construction was adjudicated a bankrupt and Trustee was duly appointed and qualified as its trustee in bankruptcy.

Ashton completed work under the construction contract on or about December 3, 1963, and so advised State the following day (Exhibit 5 in evidence), asking State to withhold any payments that might be due Construction pending submission of a claim by Ashton for the cost of completion. On or after December 31, 1963, Ashton rendered a statement to Construction under the November 1 agreement in the total sum of $33,238.60 for labor, materials and equipment; on or about January 21, 1964, Ashton made demand on Pacific for payment of the claim under the terms of the surety bond, and by letter dated February 10, 1964, Ashton made claim for the same amount against State (Exhibit 6 in evidence). On or about May 13, 1964, Pacific paid the sum of $31,000.00 to Ashton in full settlement of the latter's said claim (Exhibit 8 in evidence).

At all material times, State retained under its said construction contract with Construction the sum of $21,557.27, which sum is the subject of this controversy. The Arizona Highway Department Standard Specifications, July, 1960 (Exhibit 3 in evidence), expressly made a part of the said construction contract, provided in part:

> "9-6 Partial Payments: . . .
>
> The State may also deduct from any monthly earned statement the amount of any unsatisfied claim against the contractor for labor or materials . . . the contractor may be allowed a portion of this suspended payment, provided the State shall at all times retain an amount sufficient to enable it . . . to cover unsatisfied claims." (Page 42, Exhibit 3 in evidence).
>
> "9-8 Acceptance and Final Payment: . . .
>
> . . . Before the time of payment of said final statement, the contractor shall submit evidence satisfactory to the

> engineer that all payrolls, invoices of materials, bills and outstanding indebtedness of whatsoever nature incurred in connection with this work have been paid." (Page 44, Exhibit 3 in evidence).

Pacific at trial contended that its rights as surety, having paid the unsatisfied claim of Ashton for labor and materials, were superior to those of Trustee to the funds retained by State under any or all of the following theories:

1. It was subrogated to the rights of Construction under the said construction contract as of the date of the contract, June 28, 1963.

2. It was subrogated to the rights of State to the retained funds.

3. It was subrogated to the rights of Ashton to be paid out of the retained fund.

4. It acquired an equitable lien on the retained funds at the time it executed the surety bond, by virtue of the General Agreement of Indemnity.

5. It was entitled in its own right, as surety on the bond, to the benefit of security held by State as obligee.

The court decided (Decision, page 51, Transcript of Record on Appeal) that State had the right to retain and withhold from Construction the amount of any labor and material claims remaining unpaid from Construction, and the right to use such retained funds to pay unpaid laborers and material men; that Ashton furnished labor and materials for which it was not paid by Construction and had a right to be paid by State out of the funds retained and withheld from Construction; that Pacific, having paid Ashton, was entitled to Ashton's rights to the extent to reimburse it; and that, since Pacific had paid out more than the amount of the funds retained by State, Pacific had the right to recover such amount. Findings of fact and conclusions of

law in accordance with said Decision, and judgment that Trustee take nothing by his Complaint, and that the sum of $21,557.27 which State had deposited in the District Court's registry fund to abide the outcome of the action be paid to Pacific, were entered on April 6, 1966. Trustee's appeal followed.

ARGUMENT

At the outset, it is submitted that Construction acquired no right to the retained funds because of its breach of the condition that it "shall promptly pay . . . all laborers, mechanics, subcontractors and material men" (Exhibit 1 in evidence) and/or its failure thereafter to pay the above-described claims as principal under the bond portion of the contract, which payment by the contractor also was a condition on State's obligations under the payment provisions of the contract.

Pacific, having performed, as it was required to do as surety, following Construction's breach, is subrogated to the rights of Construction to the retained funds as of the date of the contract. *Prairie State National Bank v. United States,* 164 U.S. 227, 41 L ed 412, 17 S Ct 142 (1896).

Further, by having paid the unpaid laborers and material men, Pacific is entitled to subrogation to the right of State to retain the funds for completion of the contract, including the payment of such claims. *Henningsen v. United States Fidelity & G. Co.,* 208 U.S. 404, 52 L ed 547, 28 S Ct 389 (1908).

The rules of the two cases above cited were expressly reaffirmed as recently as 1962 in *Pearlman v. Reliance Insurance Company,* 371 U.S. 132, 9 L ed 2d 190, 83 S Ct 232 (1962), on facts very similar to the case at bar, in that there was a dispute over funds withheld by the government, involving the trustee in bankruptcy of a government con-

tractor and the contractor's payment bond surety which had paid claims in excess of the funds withheld. In holding for the surety, the court went even further than the Prairie Bank and Henningsen cases, expressly holding that the laborers and material men had a right to be paid out of the retained fund, as well as holding that the government had a right to use the retained fund to pay such laborers and material men, and that the contractor, had he paid his laborers and material men, would have become entitled to the fund. The surety, having paid the laborers and material men, was held entitled to the benefit of all the foregoing rights to the extent necessary to reimburse it.

In a separate concurring opinion in the Pearlman case, three justices chose to reach the same result without enlarging the rule of Prairie State and Henningsen, on the basis of subrogation to the rights of the government to surplus funds remaining in its hands after the contract was completed, and also relying on *Martin v. National Surety Co.*, 300 U.S. 588, 81 L ed 822, 57 S Ct 531 (1937). The latter case was decided in favor of the surety on the basis of an assignment by the contractor, in his written application for the surety bond, of the payments on the contract to the surety in the event of any breach or default in the contract. The rule of the Martin case also seems applicable herein, in light of the language in the agreement of November 19, 1962, between Construction and American Surety Company of New York, whereby the former agreed in the event of any breach or default on its part in any of the provisions of a construction contract and/or bond that the surety should be subrogated to all rights and properties of Construction in such contract, including deferred and reserved payments. The stipulated testimony of Sol Ahee establishes that Pacific executed the bond in question in reliance on and, in part, in consideration of this covenant,

which under the terms of the indemnity agreement is extended to "any other surety procured by the American Surety Company of New York." State received actual notice of the agreement and Pacific's rights thereunder on or before November 26, 1963.

As a fifth basis for establishing a right superior to Trustee in the retained funds, Pacific asserted at trial an independent right as surety to the benefit of security held by the obligee on the surety bond. See *Hochevar v. Maryland Casualty Co.*, 114 F 2d 948 (1940).

Thus, Pacific relied both on the various equitable rights of a surety defined in the Prairie State, Henningsen and Pearlman cases; an equitable right created by the agreement of Construction (Exhibit 19 in evidence), and the independent right of a surety, enunciated in Hochevar, to the benefit of the contract security.

The trial court based its decision in favor of Pacific on the doctrines enunciated in Pearlman, Prairie State, and Henningsen (Decision, page 51, Transcript of Record on Appeal) and its Findings of Fact and Conclusions of Law are consistent with the doctrines enunciated therein.

Trustee now chooses to base his appeal solely on the opinion in *Adamson v. Paonessa* (Calif., 1919) 179 Pac. 880. The case is wholly inapplicable for the following reasons:

1. It arose under the California Improvement Act of 1911; the court expressly distinguished the case from the line of authorities beginning with *Prairie State National Bank v. United States*, 164 U.S. 227, 41 L ed 412, 17 S Ct 142 (1896), on the grounds that payment under the Improvement Act was to be made, not by the person, public or private, by whom the contract was made, but by a number of different persons not parties to the contract, each of whom pays independently his separate share of the amount due. The court contrasted this with a situation

where the material men and laborers had a right as against a certain fund in addition to any recovery against the contractor or his surety, and agreed that in the latter circumstances the surety upon payment of claims would be subrogated to the claimants' rights against such fund; it based its holding on the absence of such a fund under the Improvement Act contract. Trustee asserts that this case is similar to Paonessa in that there is no such fund involved; the facts, however, belie Trustee's position and the district court so found and concluded. The pertinent portions of A.R.S. § 34-221 governing employment of contractors for public buildings and improvements at all times material hereto read as follows:

> "A. The agent shall enter into a contract with the lowest responsible bidder whose proposal is satisfactory, the terms of which shall include the following items:
>
> * * * * * * *
>
> 3. Ten per cent of all estimates shall be retained by the agent as a guarantee for complete performance of the contract, to be paid to the contractor within sixty-five days after completion or filing notice of completion of the contract, *provided the contractor has furnished the agent satisfactory receipts for all labor and material bills* and waivers of liens from any and all persons holding claims against the work." (Emphasis supplied).

The foregoing is the successor to the statute urged unsuccessfully in *Webb v. Crane Co.*, 52 Ariz. 299, 80 P.2d 698 (1938), as indicating the applicability of the mechanic's lien law to public buildings. In that case the court held that such application could not be founded upon mere inference, but required unequivocal legislative action; the holding, however, in no way affects the clear expression of legislative

intent evidenced in the 1956 enactment, quoted above, that the ten per cent retained by the contracting agent (defined in A.R.S. § 34-101 as "any state or county officer, board, commission or other governmental agency or person") is at least in part a fund for the benefit of unpaid material men and laborers. The statute requires retention, and inserts as a condition of final payment the submission of receipts for all labor and material bills. Pursuant to the foregoing statute, the payment provisions of the contract in this case provided for retention of ten per cent, and for the deduction as well of "the amount of any unsatisfied claim against the contractor for labor or materials." (Page 42, Exhibit 3 in evidence). The circumstances of the instant case, therefore, clearly fall under the line of authorities including *Prairie State National Bank v. United States*, 164 U.S. 227, 41 L ed 412, 17 S Ct 142 (1896), *Henningsen v. United States Fidelity & G. Co.*, 208 U.S. 404, 52 L ed 547, 28 S Ct 389 (1908), and *Pearlman v. Reliance Insurance Company*, 371 U.S. 132, 9 L ed 2d 190, 83 S Ct 232 (1962), rather than the Paonessa case which distinguished Prairie State because payment under the Improvement Act was to be made "by a number of different persons not parties to the contract" and because there was no fund against which the material men and laborers had any right.

2. The Paonessa case involved a dispute between the surety and an assignee "without notice of any prior assignment to the surety company and in complete ignorance of it," who advanced certain sums of money to the contractor in reliance on an assignment of all of the contractor's rights under the contract; the instant case involves a dispute between the surety and the contractor's trustee in bankruptcy. Rights asserted by the surety in *Adamson v. Paonessa* and in the instant case depend on equitable doctrines, hence the relationship of the parties and their knowl-

edge of the circumstances at material times are essential facts in determining the result of each case. Trustee suggests this in pointing an accusing finger at Pacific on page 7 of his Opening Brief for failure to verify or check the financial standing of Construction at the time the surety bond was executed in June, 1963. Contrast this failure with Construction's conduct in entering into the agreement of November 1, 1963 (Exhibit 4 in evidence) for completion of the work and thereby submitting Pacific to exposure on its surety bond for the cost of such completion, only twenty-two (22) days before the filing of the voluntary petition for relief under Chapter XI of the Bankruptcy Act. To permit the principal on the surety bond by its own act with full knowledge of its circumstances to employ another to perform under its contract, to place that other in the position of a secured creditor because of Pacific's obligations as surety, and simultaneously to limit Pacific's position to that of a general creditor in the ensuing bankruptcy, would run directly contrary to the basic principles in equity of natural justice and essential fairness without regard to form, by which that which should be done is caused to be done.

3. Because of the disparity in the identity of the disputing parties, the giving of notice or failure to give notice, on which the Paonessa case also turned, may be without application here. In any event, it is undisputed that Pacific gave notice to State by letter dated November 22, 1963 (Exhibit 10 in evidence) of its rights (as a "surety procured by the American Surety Company of New York . . .") under the indemnity agreement of November, 1962, prior to completion of the work and any right to payment arising therefrom. Unlike the Paonessa case, however, this action does not involve the claim of an assignee "without notice of the prior assignment and in complete ignorance of it."

In summary, Trustee's brief, from the Specification of Error to the Conclusion, is based on a misconception of the ultimate issue herein. While Trustee asserts that Pacific is trying to become a secured creditor of a bankrupt estate, the true issue is whether Pacific, like the surety in the Pearlman case, acquired rights to the retained fund superior to those of Trustee, Construction, or the latter's general creditors. Construction, by terms of the surety bond in its contract with State if by no other provision, promised to pay all laborers and material men on said contract. It failed to do so and Pacific as surety was required to satisfy unpaid claims for labor and material in excess of the funds retained under the contract by State. Construction, thus having breached its contract, never became entitled to those funds, whereas Pacific by its performance acquired the right thereto, be it by subrogation to the rights of the principal on its bond, the unpaid claimants, the State of Arizona, or the assignment in the General Agreement of Indemnity. The judgment of the trial court should be affirmed.

Respectfully submitted,

Chandler, Tullar, Udall & Richmond
By James L. Richmond
Attorneys for Appellee

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

James L. Richmond

No. 21,169

In the

United States Court of Appeals

for the Ninth Circuit

A. BATES BUTLER, Trustee of CONSTRUCTION MATERIALS CO.,

Appellant,

vs.

PACIFIC NATIONAL INSURANCE COMPANY, nka TRANSAMERICA INSURANCE COMPANY,

Appellee.

Petition for Rehearing

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Appellee.

Petition for Rehearing

STATEMENT OF GROUNDS FOR REHEARING

Appellee petitions for rehearing in the above-entitled appeal on the following grounds:

I

The Court of Appeals erred in applying the rule of *Kennedy v. Powell,* 366 F.2d 346 (9th Cir. 1966), holding that a cash bond deposited by the bankrupt to obtain a contractor's license was property of the bankrupt and vested in the trustee, because the funds in the instant case, unlike such cash deposit, never were the property of the bankrupt

but were retained by the State of Arizona for the benefit of unpaid laborers and materialmen, to whose position appellee is subrogated following payment of the bankrupt's obligations, and no property interest therein ever could vest in the estate of the bankrupt, as pointed out on page 3 of the Court's opinion, until it paid such laborers or materialmen, which it failed to do. See *Pearlman v. Reliance Ins. Co.,* 371 U.S. 132 (1962), on which this Court relies in establishing the priority of the unpaid materialman over the contractor's trustee in bankruptcy.

II

The Court erred in reversing the judgment of the district court in favor of appellee and remanding the case for pro rata distribution of the funds by the trustee among unpaid laborers and materialmen for whose benefit the funds were retained because the record herein discloses that all creditors of that class have been paid by appellee, which thereby was subrogated to all such claims, rather than that of The Ashton Company alone. See Page No. 50, Transcript of Record on Appeal, including the following exhibits: Plaintiff's Exhibit 14, reciting that the only claims on file with the State of Arizona were those of Babby Building Specialties, Inc., Commonwealth Electric Company of Arizona and The Ashton Company; Plaintiff's Exhibit 17, receipt and assignment to appellee of the claim of Babby Building Specialties, Inc., for the sum of $385.78; Plaintiff's Exhibit 18, receipt and assignment to appellee of the claim of Commonwealth Electric Company of Arizona for the sum of $1,201.50; Plaintiff's Exhibit 8, receipt and assignment to appellee of the claim of The Ashton Company for the sum of $31,000.00; and Plaintiff's Exhibit 1, appellee's surety bond in the penal sum of $53,587.57, for the express benefit of "any and all creditors . . . for any and all claims, bills, accounts, and demands made and contracted and incurred

for or on account of labor or services performed, materials, supplies, or provisions furnished . . . in the performance of said contract . . ."; reflecting not only that all claims totaling $32,587.28 were paid by appellee but that a balance of $21,000.00 of the penal sum of the bond was not exhausted, for lack of additional claims by creditors of the class secured under Ariz. Rev. Stat. Sec. 34-221(A)(3).

Respectfully submitted,

Chandler, Tullar, Udall & Richmond

By James L. Richmond
Attorneys for Appellee

I certify that in my judgment the foregoing Petition for Rehearing is well founded and that it is not interposed for delay.

James L. Richmond

NO. 21170

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

PAYNE METAL ENTERPRISES, LIMITED, a corporation, and PAYNE MANUFACTURING COMPANY, LIMITED, a corporation,

Appellants,

vs.

JAMES E. McPHEE and ANCHOR PRODUCTS, INC., a corporation,

Appellees.

APPELLANTS' OPENING BRIEF

APPEAL FROM
THE UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF CALIFORNIA

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TOPICAL INDEX

TABLE OF AUTHORITIES

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Appellees.

APPELLANTS' OPENING BRIEF

STATEMENT OF JURISDICTION

On January 29, 1961, plaintiff-appellants, Payne Metal Enterprises, Ltd. and Payne Manufacturing Company, Ltd., filed a Complaint in the District Court for the Southern District of California against defendant-appellees, James E. McPhee and Anchor Products, Inc. for a declaratory judgment that McPhee U. S. Design Patent No. 176,986 was invalid and not infringed (Cl. Tr. 1-6). Defendant-appellees denied invalidity and noninfringement and counterclaimed for infringement (Cl. Tr. 9-13).

After trial, the District Court filed an Interlocutory

Judgment and Order on March 31, 1966, holding said patent valid and infringed (Cl. Tr. 186-188). On April 28, 1966, plaintiff-appellants filed a notice of appeal (Cl. Tr. 190-191).

The District Court had jurisdiction under 28 U. S. C. §§ 1338(a) and 2201.

This Court has jurisdiction to review the Interlocutory Judgment and Order under 28 U. S. C. §§ 1291 and 1292(4) and Rule 73(a) of the Federal Rules of Civil Procedure.

CONCISE STATEMENT OF THE CASE

McPhee U. S. Design Patent No. 176, 986 (Cl. Tr. 34), the patent in suit, was filed December 7, 1954 and issued February 28, 1956 on a "Liquid Pourer". The patent was marked Dfts. Ex. A and the design thereof is shown in Pltfs. Ex. 10, which is reproduced in this brief following page 5.

This design is the same as Fig. 1 of McPhee U. S. Patent No. 2, 667, 290 (Cl. Tr. 35), issued January 26, 1954, with the addition of a skirt or depending flange. Fig. 1 of said patent is also shown in Pltfs. Ex. 10. McPhee testified as follows (Rep. Tr. 257-258):

> "Q. So the only thing that you really added by virtue of design patent '986 was the skirt; is that correct?
>
> "A. Do you mean the physical addition?
>
> "Q. Yes.

"A. Yes.

"Q. And that is the only element of the design that is new, isn't that correct?

"A. Physical addition of the skirt."

Skirts were old in the art. See Australian Patent No. 9,658 and Maloney U.S. Patent No. 2,275,051 (Cl. Tr. 42-49), which are contained in Pltfs. Ex. 3. The Australian design is also shown in Pltfs. Ex. 10 following page 5 of this brief.

McPhee admitted that his skirt is conical (Rep. Tr. 27, 30). This was an old shape selected for the basic reason that it facilitated the manufacture by the use of the die casting process. Said McPhee (Rep. Tr. 263-265):

"Q. Now, can you tell me why you chose the angular shape of the skirt, as shown in the drawings Figures 1 to 3 of Exhibit A, above any other shape?

"A. The basic reason is that it is a real fine application of the die-casting process."

Also, the McPhee design is primarily functional because it "cover[s] up the messy connection between a bottle top and . . . [the] pourer" (Rep. Tr. 65, 260-261) and "surround[s] and protect[s] the uppermost part of the cork". See Australian Patent No. 9,658, Col. 3, lines 33-34 (Cl. Tr. 43).

Thus, the McPhee Design Patent covers the addition of an old, functional skirt to the old combination shown in Fig. 1 of

McPhee's mechanical patent No. 2, 667,290.

Plaintiff's alleged infringing devices, Dfts. Exhibits B and C, are shown in Pltfs. Ex. 10 and are labelled "Accused Payne Mod. #508" and "Accused Payne Mod. #542",respectively. These devices differ from the McPhee design in the following respects, among others:

(1) The bodies of the alleged infringing devices are "closer to a ball" than the patented design (Rep. Tr. 39).

(2) The alleged infringing devices have an angular bead around the ball as distinguished from the horizontal bead of McPhee's patent (Rep. Tr. 41).

(3) The pouring spout of the alleged infringing devices extend farther above the body than in the patented design (Rep. Tr. 41).

(4) The alleged infringing devices have bell-shaped or curvilinear skirts while the patented design shows a skirt with straight sides (Rep. Tr. 42-43).

SPECIFICATION OF ERRORS

1. Findings of Fact Nos. 7, 8, 9, 10, 11 and 12 are unsupported by the evidence.

2. Finding of Fact No. 14 is unsupported by the evidence insofar as it states that "the Patent Office Examiner, during the prosecution of the McPhee patent in suit, No. Des. 176,986, had before him the most pertinent prior art references". The Examiner did not have Maloney U.S. Patent No. 2,275,051 and other pertinent prior art references before him.

3. The second sentence of Finding of Fact No. 15 is an erroneous Conclusion of Law and is unsupported by any findings of fact or evidence.

4. The second sentence of Finding of Fact No. 16 is an erroneous Conclusion of Law and is unsupported by any findings of fact or evidence.

5. Findings of Fact Nos. 18 and 19 are erroneous Conclusions of Law and are unsupported by any findings of fact or evidence.

6. Finding of Fact No. 20 is not supported by the evidence.

7. Finding of Fact No. 23 is an erroneous Conclusion of Law.

8. Finding of Fact No. 25 is unsupported by the evidence.

9. Finding of Fact No. 26 is unsupported by the evidence.

10. Finding of Fact No. 27 is unsupported by the evidence.

11. The Court erred in Conclusions of Law 3 to 9 inclusive because they are unsupported by any findings of fact or evidence.

12. The Court erred in refusing to find or conclude that McPhee U. S. Design Patent No. 176, 986 was not new, original or ornamental.

13. The Court erred in refusing to find or conclude that McPhee U. S. Design Patent No. 176, 986 would have been obvious at the time the alleged invention was made to a person having ordinary skill in the art to which the subject matter pertains under Title 35, U. S. C. §103.

14. The Court erred in refusing to find or conclude that McPhee U. S. Design Patent No. 176, 986 was anticipated under Title 35, U. S. C. §§ 102(a), (b) and (f).

15. The Court erred in refusing to find that McPhee U. S. Design Patent No. 176, 986 was not infringed by plaintiffs or either of them.

SUMMARY OF ARGUMENT

1. The rules relating to findings of fact should be strictly enforced against defendants because the District Court adopted defendants' findings without change. This Court should therefore require that the defendants cite record references in support of all challenged findings and should consider the failure to make critical findings as an admission that there was no evidence

to support such findings.

2. There is almost a presumption against the validity of a design patent.

3. The findings of commercial success are clearly erroneous because the devices sold were not manufactured in accordance with the patent and the defendants did not prove that the invention contributed in any material degree to the commercial success.

4. The alleged invention was obvious because McPhee merely changed the dimensions of an old element, the skirt or flange and added it to the old elements shown in his mechanical patent without the exercise of invention.

5. The design was dictated by functional or mechanical requirements and was not ornamental.

6. Plaintiffs did not infringe because the resemblances to the patented design would not deceive an ordinary observer, inducing him to purchase the alleged infringing device supposing it to be the patented design.

I

THE APPLICABLE STATUTES

35 U.S.C. § 171 provides that:

> Whoever invents any new, original and ornamental design for an article of manufacture may obtain a patent therefor, subject to the conditions and

requirements of this title.

The provisions of this title relating to patents for inventions shall apply to patents for designs, except as otherwise provided.

35 U.S.C. § 102(b) states that:

A person shall be entitled to a patent unless -

* * *

(b) the invention was patented or described in a printed publication in this or a foreign country or in public use or on sale in this country; more than one year prior to the date of the application for patent in the United States, or . . . .

35 U.S.C. § 103 provides that:

A patent may not be obtained though the invention is not identically disclosed or described as set forth in section 102 of this title, if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains. Patentability shall not be negatived by the manner in which the invention was made.

II

THE RULES RELATING TO FINDINGS OF FACT SHOULD BE STRICTLY ENFORCED AGAINST DEFENDANTS.

In an Order for Findings of Fact, Conclusions of Law and Judgment, dated March 18, 1966 (Cl. Tr. 169-170), the District Court found United States Design Patent No. 176, 986 valid and infringed and ordered the prevailing defendants to prepare proposed findings of fact and conclusions of law. The District Court did not write a memorandum opinion which could be used to supplement these findings and conclusions. See Stone v. Farnell, 239 F. 2d 750, 23 F. R. Serv. 52 a. 3, Case 1 (9th Cir. 1956); but see Duplex Straw v. Harold Leonard, 229 F. Supp. 401, 141 USPQ 332, 333 (S. D. Calif. 1964).

Plaintiffs filed objections to defendants' proposed findings and conclusions in which they urged the Court "to disregard defendants' proposed findings and make its own independent findings" (Cl. Tr. 171-174). Plaintiffs also called the Court's attention to Edward Valves v. Cameron Iron Works, 289 F. 2d 355, 129 USPQ 131 (5th Cir. 1961), cert. denied 368 U. S. 833, 131 USPQ 498 (1961), where the Court said:

> "We strongly disapprove any denigration of the trial judge's important function of fact-finding. Findings and conclusions which represent a trial judge's 'independent judicial labors and study' are far more helpful to this Court than the mechanical

adoption of the successful attorney's 'suggested' findings. Kinnear-Weed Corp. v. Humble Oil & Ref. Co., 5 Cir. 1958, 259 F.2d 398, 401, 119 USPQ 10, 11-12; United States v. Forness, 2 Cir. 1942, 125 F.2d 928, 942."

Accord: Roberts v. Ross, 344 F.2d 747, 9 F.R. Serv.2d 52 a.11, Case 1 (3rd Cir. 1965); Rooted Hair v. Ideal Toy, 329 F.2d 761, 141 USPQ 540, 542 (2nd Cir. 1964), cert. denied 379 U.S. 831, 143 USPQ 465 (1964); Nyyssonen v. Bendix, 342 F.2d 531, 144 USPQ 555, 556 (1st Cir. 1965), cert. denied 382 U.S. 847, 147 USPQ 540 (1965).

Nevertheless, the District Court followed the condemned practice of adopting without change the proposed findings and conclusions of the successful party.

In United States v. El Paso Natural Gas, 376 U.S. 651, 8 F.R. Serv.2d 52 a.11, Case 1 (1964), the Supreme Court recently disregarded similar "mechanically adopted" findings and reversed a judgment for defendant. In footnote 4, the Court quoted with approval the following words of Judge J. Skelly Wright of the Court of Appeals of the District of Columbia, speaking to a seminar for newly appointed United States District Court Judges:

> "Who shall prepare the findings? Rule 52 says the court shall prepare the findings. 'The court shall find the facts specially and state separately its conclusions of law.' We all know what has happened.

Many courts simply decide the case in favor of the plaintiff or the defendant, have him prepare the findings of fact and conclusions of law and sign them. This has been denounced by every court of appeals save one. This is an abandonment of the duty and the trust that has been placed in the judge by these rules. It is a noncompliance with Rule 52 specifically and it betrays the primary purpose of Rule 52 - the primary purpose being that the preparation of these findings by the judge shall assist in the adjudication of the lawsuit.

"I suggest to you strongly that you avoid as far as you possibly can simply signing what some lawyer puts under your nose. These lawyers, and properly so, in their zeal and advocacy and their enthusiasm are going to state the case for their side in these findings as strongly as they possibly can. When these findings get to the courts of appeals they won't be worth the paper they are written on as far as assisting the court of appeals in determining why the judge decided the case."

Despite this condemnation, the Supreme Court said that such findings "are not to be rejected out of hand, and they will stand if supported by evidence".

Under the circumstances of this case, however, plaintiffs

ask this Court to strictly enforce Rule 18(3) of this Court of Appeals, which provides that:

> "When findings are specified as error in the appellant's brief, and such specification is argued therein, the appellee's brief shall contain record references to the evidence relied upon by appellee as supporting the challenged finding."

Also, since the prevailing party ordinarily prepares as many favorable findings as possible, plaintiffs further ask the Court to enforce the rule that the failure to make critical findings is tantamount to a holding, or admission, that there was no evidence to support such findings. Neal v. Thomas Organ, 241 F. Supp. 1020, 145 USPQ 315 (S. D. Calif. 1965); Jaybee v. Ajax, 287 F. 2d 228, 128 USPQ 278, 280 (9th Cir. 1961).

III

THERE IS ALMOST A PRESUMPTION AGAINST THE VALIDITY OF A DESIGN PATENT.

In Chas. D. Briddell, Inc. v. Alglobe Trading Corp., 194 F. 2d 416, 419, 92 USPQ 100, 102 (2nd Cir. 1952), the Court said:

> "To obtain a valid design patent is exceedingly difficult."

In Falcon Industries v. R. S. Herbert Co., 128 F. Supp. 204, 104 USPQ 301, 305 (E. D. N. Y. 1955), the Court commented on the

Briddell case and another as follows:

> "Neither opinion says bluntly that there is a presumption against validity . . . but the judicial attitude concerning design patents almost seems to go so far." 1/

Also, this Court has said that "the presumption of validity of administrative grant has been in recent years almost reduced to nullity". Jacuzzi Bros. Inc. v. Berkeley Pump Co., 191 F. 2d 632, 91 USPQ 24, 27 (9th Cir. 1951). The presumption is "infinitely weaker" than that which attends findings of other administrative bodies. Hansen v. Safeway Stores, 238 F. 2d 336, 110 USPQ 170, 172 (9th Cir. 1956). Contributing to this trend is the Patent Office policy of granting patents where there is doubt on the question of patentability. In re Scott, 139 USPQ 297, 300 (CCPA 1963); In re Pavelecka, 317 F. 2d 932, 137 USPQ 788, 791 (CCPA 1963); In re Sporck, 301 F. 2d 686, 133 USPQ 360, 364 (CCPA 1962).

The situation was recently well summed-up in Mohasco Industries, Inc. v. E. T. Barwock Mills, Inc., 221 F. Supp. 191, 139 USPQ 148, 152-153 (N. D. Ga. 1963), aff'd. 340 F. 2d 319, 144 USPQ 288 (5th Cir. 1965):

1/ This Circuit has passed on the validity of design patents in six cases in the last twenty-five years. Five of the six were held invalid. Alladin Plastics v. Jerrold Stephan, ___ F. 2d ___, 150 USPQ 10 (9th Cir. 1966); Bentley v. Sunset House, ___ F. 2d ___, 149 USPQ 152 (9th Cir. 1966); Bliss v. Gotham, 316 F. 2d 848, 137 USPQ 189, 191 (9th Cir. 1963); Jaybee v. Ajax, 287 F. 2d 222, 128 USPQ 278 (9th Cir. 1961); Margarian v. Detroit Products, 128 F. 2d 544, 53 USPQ 658 (9th Cir. 1942).

"To be sure, the issuance of a patent carries with it a presumption of validity (35 USC § 282) but the Courts recognize the problems which inhere in an immense administrative operation such as is carried on by the Patent Office and have minimized the presumption accordingly. See Gentzel v. Manning, Maxwell & Moore, Inc. 230 F. 2d 341, 108 USPQ 353, cert. denied 352 U. S. 840, 111 USPQ 467; Wabash Corporation v. Ross Electric Corporation, 187 F. 2d 577, 88 USPQ 393.

"The fact that the Patent Office issues a patent does not necessarily mean that the subject matter was patentable. Pursuant to a rule of long-standing, still in existence today, the Patent Office must grant a patent even when in doubt as to its patentability. In re Thomson, 26 APP. D. C. 419, 1906 C. D. 566, 571 (1906):

" 'In case of ordinary doubt, the policy of the patent system, as customarily maintained in the Patent Office, has been to give the applicant the benefit thereof, because no absolute right of property is conferred by the grant of a patent. (Ex parte Fanshawe, C. D. 1891, 203, 57 O. G. 1127). The patentee is merely put in a position to assert his prima facie right against infringers who may, in their defense, raise the question of the validity of the patent and

have the same finally adjudicated in the light of a full presentation and consideration of all the evidence attainable in respect of anticipation, prior knowledge, use and the like.'

"See also Application of Hummer, 241 F. 2d 742, 746, 113 USPQ 66, 69, and Application of Citron, 251 F. 2d 619, 620, 116 USPQ 409, 410.

"Considering what has been said, it is hardly surprising that Courts have observed that the standard of patentability in the Patent Office is below that required by the Courts. Packwood v. Briggs & Stratton Corporation, 195 F. 2d 971, 974, 93 USPQ 274, 276 (3rd Cir. 1952), cert. denied 344 U. S. 844, 95 USPQ 418 (1952); Picard v. United Aircraft Corporation, 128 F. 2d 632, 541, 53 USPQ 563, 572 (2d Cir. 1942), cert. denied 317 U. S. 651, 55 USPQ 493 (1942):

" 'The Patent Office grants from 50,000 to 100,000 patents each year. The Committee of the Science Advisory Board reported that it was one of the primary defects in our patent system that the Patent Office issues "enormous number of patents, many of which should never be issued * * *". That probably means, as the Committee intimated, that the standard of inventiveness employed by the Patent Office is far below that employed by the courts.' "

In <u>Graham v. John Deere,</u> ___ U. S. ___, 148 USPQ 459, 467 (1966),

the Supreme Court agreed, saying:

> "We have observed a notorious difference between the standards applied by the Patent Office and by the courts. While many reasons can be adduced to explain the discrepancy, one may well be the free rein often exercised by examiners in their use of the concept of 'invention'. In this connection we note that the Patent Office is confronted with a most difficult task. Almost 100, 000 applications for patents are filed each year. Of these, about 50, 000 are granted with the result that the backlog now runs well over 200, 000. United States Patent Office, Index of Patents, p. 1123 (1963). This is itself a compelling reason for the Commissioner to strictly adhere to the 1952 Act as interpreted here. This would we believe, not only expedite disposition but bring about a closer concurrence between administrative and judicial precedent."

Accord: S. W. Farber, Inc. v. Texas Instruments, Inc., 230 F. Supp. 883, 141 USPQ 473, 479 (D. Del. 1964); See also Berghane v. Radio Corp., 116 F. Supp. 200, 99 USPQ 264, 268 (D. Del. 1953), aff'd. 217 F. 2d 490, 103 USPQ 406 (3rd Cir. 1954); Cf. Wabash v. Ross Electric, 187 F. 2d 577, 88 USPQ 393, 403 (2nd Cir. 1951).

The presumption of validity is not evidence and disappears as soon as direct or positive evidence is introduced. Lage v. Caldwell Mfg. Co., 221 F. Supp. 802, 138 USPQ 497, 500-501

(D. Nebr. 1963); Lorenz v. F. W. Woodworth, 305 F. 2d 102, 134 USPQ 152, 154-155 (2nd Cir. 1962); U. S. Rubber v. Consolidated Trimming, 218 F. Supp. 498, 138 USPQ 14, 18 (S. D. N. Y. 1963); Bussemer v. Artwire, 231 F. Supp. 798, 142 USPQ 323, 325 (S. D. N. Y. 1964); Rothe v. Ford Motor Co., 253 F. 2d 353, 116 USPQ 497, 499 (D. C. Cir. 1958); B & S Screw Products v. Cleveland Stamping, 233 F. Supp. 845, 143 USPQ 284, 289 (N. D. Ohio 1964); Davis Harvester v. Long Manufacturing Co., ___ F. Supp. ___, 149 USPQ 420, 434 (E. D. N. C. 1966). Cf. Gray v. Montgomery-Ward, 244 F. Supp. 760, 139 USPQ 376 (D. Ore. 1963).

Furthermore, one prior art reference which was not considered by the Patent Office may overthrow the presumption and render the patent invalid. Monroe Auto Equipment v. Superior Industries, 332 F. 2d 473, 141 USPQ 710, 716 (9th Cir. 1964), cert. denied 379 U. S. 888, 143 USPQ 465 (1964); Dresser Industries v. Smith-Blair, 322 F. 2d 878, 139 USPQ 1, 9 (9th Cir. 1963); Jaybee v. Ajax, 287 F. 2d 228, 128 USPQ 278, 280 (9th Cir. 1961).

IV

THE FINDINGS OF COMMERCIAL SUCCESS ARE CLEARLY ERRONEOUS.

The law on commercial success in design cases is set forth in Jaybee v. Ajax, 287 F. 2d 228, 128 USPQ 278, 280 (9th Cir. 1961), where the Court said:

"In support of the validity of the patent, appellee urges upon us the commercial success of the article. Such was the finding of the District Court. It is true that commercial success may be taken into consideration in determining the validity of the patent. The trend is to use such success in determining the validity of a patent as a makeweight only where the patentability question is close. Pointer v. Six Wheel Corporation, 9 Cir., 1949, 177 F.2d 153, 156, 83 USPQ 43, 46. Such success should not be relied upon to establish patentability except in cases which are otherwise doubtful. In re Application of Lange, 1955, 228 F.2d 243, 246, 43 CCPA 714, 108 USPQ 142, 143. However, where invention is plainly lacking, a commercial success cannot fill the void. Jungersen v. Ostby & Barton Co., 335 U.S. 560, 567, 80 USPQ 32, 34-35."

The findings of commercial success, Findings of Fact Nos. 7, 8, 9, 10 and 11, are clearly erroneous for three reasons: First, defendants did not prove that the alleged commercially successful device was manufactured in accordance with the patent. On the contrary, their expert admitted that the manufactured device had multiple horizontal lines at the top of the skirt instead of one, as shown in the patent, and that the manufactured device had a sharp shoulder at the top of the skirt (Rep. Tr. 29). See also

Pltfs. Ex. 10 which shows the "actual pourer manufactured by Anchor". Second, since invention was plainly lacking, the District Court should not have considered commercial success at all. Third, even assuming that this was a doubtful case, there was no competent evidence of commercial success because the defendants failed to prove that the invention (the addition of the skirt) contributed in any material degree to the commercial success. Marconi Wireless Telegraph v. United States, 320 U. S. 1, 57 USPQ 471, 486 (1943). Accord: Converse v. Brenner, ___ F. Supp. ___, 151 USPQ 12, 13-14 (D. C. 1966).

Many factors are responsible for commercial success other than invention. These factors include "generally favorable business conditions in the . . . industry", Gunter & Cooke v. Southern Electric Service, ___ F. Supp. ___, 149 USPQ 438, 451 (M. D. N. C. 1966), "a general need" for a generic class of device, including both the patented and prior art devices, Keiser v. High Point, 311 F. 2d 850, 136 USPQ 612, 614 (4th Cir. 1962), "low production cost", Lage v. Caldwell, 221 F. Supp. 802, 138 USPQ 497, 502 (D. Nebr. 1963), "modern advertising techniques", Stiegele v. J. M. Moore, 312 F. 2d 588, 136 USPQ 230, 232 (2nd Cir. 1963), "increase in advertising expenditures", Modern Millinery v. Bows Box, 219 F. Supp. 615, 138 USPQ 449, 451 (E. D. Pa. 1963), "sales promotion", In re Boyer, ___ F. 2d ___, 150 USPQ 441, 444 (CCPA 1966), and other factors. Mannix v. Healey, 341 F. 2d 1009, 144 USPQ 611, 616 (5th Cir. 1965).

Sales figures alone fall short of establishing commercial

success, North Electric v. United States, ___ F. 2d ___, 150 USPQ 464, 466 (Ct. Cl. 1966), even though they may show "an excellent record of sales growth". T. P. Laboratories, Inc. v. Huge, ___ F. Supp. ___, 151 USPQ 328, 333 (E. D. Wisc. 1965). As this Court said in Jaybee v. Ajax, 287 F. 2d 228, 128 USPQ 278, 280 (9th Cir. 1961):

> "Where there is no showing, as in the present case, on how much of the commercial success was due to the advance in design or how much might have been due to other factors, the claimed commercial success is of little, if any, benefit to the trier of the facts."

Accord: Simmons v. Brandwein, 111 USPQ 171, 176 (N. D. Ill. 1956), aff'd. 250 F. 2d 440,115 USPQ 307 (7th Cir. 1957). Cf. Hollister v. Twentiers, 217 F. Supp. 591, 135 USPQ 119, 121 (D. Ariz. 1962), aff'd. 319 F. 2d 898, 138 USPQ 473 (9th Cir. 1963).

Here, defendants offered no evidence of expenditures for advertising and promotion nor did defendants offer any evidence that the patented device drove its predecessors out of the market. Cf. Schering v. Gilbert, 153 F. 2d 428, 68 USPQ 84, 87 (2nd Cir. 1946). McPhee did not even know the size of the pourer market (Rep. Tr. 265).

On the other hand, the logical inference from the evidence is that the increase in sales of the patented design was due to the mechanical features covered by McPhee's U. S. Patent No. 2, 667, 290, and by the emphasis placed on the patented design in defendants' catalogue (Rep. Tr. 260, 266-268).

V

FINDINGS OF FACT 15, 16, 18 AND 19 ARE CONCLUSORY STATEMENTS MISNAMED FINDINGS OF FACT.

Findings of Fact 15, 16 and 19 state, in effect, that the patented design would not have been "obvious . . . to a person having ordinary skill in the art". Finding of Fact 18 states that there is no "anticipation" of the McPhee invention.

In National Lead v. Western Lead, 291 F. 2d 447, 130 USPQ 4, (9th Cir. 1961), the Court held that similar findings (Nos. 7 and 8) were "little more than a paraphrase" of the statute and "should better be denominated a conclusion of law". Cf. Welsh v. Strolee, 290 F. 2d 509, 129 USPQ 175, 177 (9th Cir. 1961).

Furthermore, there are no genuine Findings of Fact to support these Conclusions of Law. For example, there are no findings of fact on "the level of ordinary skill in the pertinent art". See Graham v. John Deere, ___ U. S. ___, 148 USPQ 459, 467 (1966). Rule 52(a) of the Federal Rules of Civil Procedure states that the trial court "shall find the facts specially and state separately its conclusions of law thereon". The rule is not satisfied where the Court makes conclusions substantially in the language of the statute. The opinion of a paid expert, who has more than ordinary skill in the art, is not enough; the expert must state "facts to show why the invention would not be obvious". In re Luvisi, 342 F. 2d 102, 144 USPQ 646, 651 (CCPA 1965). So, in the words of Judge Browning in Griffith Rubber Mills v. Hoffar,

313 F. 2d 1, 136 USPQ 332, 338 (9th Cir. 1963):

> "There was no objective evidence that the combination was less obvious than it appears."

While the question of validity "may" turn on a question of fact, Pressteel v. Halo, 314 F. 2d 695, 137 USPQ 25, 27 (9th Cir. 1963), the defendants' failure to submit any genuine findings was an admission that there were no issues of fact and that the question of validity in this case was solely a question of law. Cf. Bentley v. Sunset House, ___ F. 2d ___, 149 USPQ 152, 154 (9th Cir. 1966); Brunswick v. Columbia Industries, ___ F. 2d ___, 150 USPQ 83, 85 (9th Cir. 1966); Continental Connector v. Houston Fearless, 350 F. 2d 183, 146 USPQ 630, 636 (9th Cir. 1965); Monroe v. Superior, 332 F. 2d 473, 141 USPQ 710, 713 (9th Cir. 1964); Farr v. American Air Filter, 318 F. 2d 500, 137 USPQ 627 (9th Cir. 1963).

VI

THE ALLEGED INVENTION WAS OBVIOUS

35 U. S. C. § 103 is applicable to design patents. 35 U. S. C. § 171; In re Levy, 310 F. 2d 751, 135 USPQ 447, 448 (CCPA 1962); In re Frick, 275 F. 2d 741, 125 USPQ 191, 192 (CCPA 1960). Sec. 103 provides that:

> "A patent may not be obtained though the invention is not identically disclosed or described as set forth in section 102 of this title, if the differences

between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains."

The standard of invention required for design patents is the same as that for mechanical patents. In both cases there must be originality in the exercise of the inventive faculty. A streamlined and pleasing appearance is insufficient in the absence of invention. Brown v. DeBell, 243 F.2d 200, 113 USPQ 172, 173 (9th Cir. 1957); Patriarca Mfg., Inc. v. Sosnick, 169 F. Supp. 204, 120 USPQ 143, 146, 148 (S.D. Calif. 1958), aff'd. 278 F.2d 389, 125 USPQ 260 (9th Cir. 1960). This is especially true where one element of the design "is perhaps a refinement over prior structures" and the other elements are contained in or suggested by the prior art. Margarian v. Detroit Products Company, 128 F.2d 544, 53 USPQ 658, 660 (9th Cir. 1942).

Invention is the "prime" requisite to validity. Tourneau v. Tishman, 119 F. Supp. 593, 100 USPQ 350, 353 (S.D. N.Y. 1953), aff'd. 211 F.2d 240, 100 USPQ 334 (2nd Cir. 1954). The design must demand some exceptional talent beyond the skill of the ordinary designer chargeable with knowledge of the prior art. Bliss v. Gotham, 316 F.2d 848, 137 USPQ 189, 191 (9th Cir. 1963); Patriarca Mfg., Inc. v. Sosnick, supra (at page 148); Jaybee Mfg. Corp. v. Ajax Hardward Mfg. Corp., 287 F.2d 222, 230, 128

USPQ 278, 280 (9th Cir. 1961); Duplex Straw Dispenser Co. v. Harold Leonard & Co., 229 F. Supp. 401, 141 USPQ 332, 333 (S. D. Calif. 1964). And there must be a "substantial difference" over the prior art. The fact that some dimensions are changed in a different degree than others is not patentably significant. Duplex Straw Dispenser Co. v. Harold Leonard & Co., supra.

A utilitarian or mechanical device may invalidate a design patent. Thabet Mfg. Co. v. Koolvent Metal Awning, 226 F. 2d 207 107 USPQ 61, 65 (6th Cir. 1955). And the Court may compare component parts of a design to show that they are so similar to prior art that no invention is involved. Continental Art v. Bertolozzi, 232 F. 2d 131, 109 USPQ 231 (7th Cir. 1956).

The facts here are clear: McPhee merely added an old skirt or flange to Fig. 1 of his U. S. Patent No. 2, 667, 290 (Rep. Tr. 257-258). The skirt or flange was designed to cover the neck of the bottle and protect the cork (Rep. Tr. 65, 260-261). The conical shape was chosen to permit die casting (Rep. Tr. 263-265).

McPhee was charged with knowledge of all the prior art disclosed at the time of his invention, irrespective of whether persons of ordinary skill in the field, or he himself, or anyone else, actually possessed such all-encompassing familiarity with prior disclosures. Walker v. General Motors, ___ F. 2d ___, 149 USPQ 472, 474-475 (9th Cir. 1966). Thus, he was charged with knowledge of Fig. 1 of his own U. S. Patent No. 2, 667, 290, Maloney U. S. Patent No. 2, 275, 051, and the Australian Patent No. 9658, the last two patents of which disclose skirts or flanges. He

was also charged with knowledge of the die casting process.

The proper way to apply the § 103 test is to first picture the inventor as working in his shop with the prior art references - which he is presumed to know hanging on the walls around him. In re Winslow, ___ F. 2d ___, 151 USPQ 48, 51 (CCPA 1966).

The Court should therefore picture McPhee in his shop seeking a way to "cover up the messy connection between . . . (the) bottle top and a pourer" (Rep. Tr. 65) and to protect the cork. Looking up on his wall, he could see the flanges or skirts in the Australian and Maloney patents. He could also see the conical shape dictated by the die casting process. In this setting, how can his design be said to meet the "rigorous" standard of patentable invention? See Berkeley Pump v. Jacuzzi, 214 F. 2d 785, 102 USPQ 100, 102 (9th Cir. 1954).

Clearly, the prior art contained or suggested all the elements of McPhee's design. He merely refined one element, the skirt, by adopting a conical shape dictated by the die casting process and then lengthened it to cover the neck and cork. See King Ventilating v. St. James, 17 F. 2d 357, aff'd. 26 F. 2d 357 (8th Cir.); Patents for Designs by Shoemaker, § 33, pp. 44-49.

The prior art in this case was simple and if the ordinary skill of persons in the art was "postulated at the minimum conceivable level", McPhee's invention would have been obvious. Walker v. General Motors, ___ F. 2d ___, 149 USPQ 472, 475 (9th Cir. 1966); Alladin Plastics v. Jerrold Stephan, ___ F. 2d ___, 150 USPQ 10, 11 (9th Cir. 1966). Any other holding would simply

withdraw what was already known and "diminish the resources available to skillful men". Great A. & P. Tea Co. v. Supermarket Equipment Co., 340 U.S. 147, 87 USPQ 303, 306 (1951).

McPhee's design was, at most, the normal progress which results when ordinary taste and judgment are applied to that which has already been created or discovered. Jaybee v. Ajax, 287 F.2d 228, 128 USPQ 278, 280 (9th Cir. 1961).

VII

THE DESIGN WAS NOT ORNAMENTAL

35 U.S.C. § 271 requires that a design patent be "ornamental". A design is not ornamental if it was "dictated primarily by functional or mechanical requirements and any ornamental or pleasing effect was merely a by-product thereof". Bliss v. Gotham, 316 F.2d 848, 137 USPQ 189, 191 (9th Cir. 1963); Bentley v. Sunset House, ___ F.2d ___, 149 USPQ 152, 156 (9th Cir. 1966). Hygienic Specialties v. H. G. Salzman, 302 F.2d 614, 133 USPQ 96, 100 (9th Cir. 1962); Patriarca v. Sosnick, 169 F. Supp. 204, 120 USPQ 143, 146 (S.D. Calif. 1958), aff'd. 278 F.2d 389, 125 USPQ 260 (9th Cir. 1960); Majestic v. Westinghouse, 276 F.2d 676, 678 (9th Cir. 1921).

As already pointed out, the shape of the skirt was dictated by the die casting process (Rep. Tr. 263-265) and by the requirement that it surround and protect the neck of the bottle and the cork (Rep. Tr. 65, 260-261).

Significantly, the findings and conclusions prepared by defendants did not include a finding or conclusion that the design was "ornamental". This was an admission that no such finding or conclusion could be made and, regardless of any other defect, should make it impossible for the judgment to be sustained. Cf. Bergman v. Aluminum Lock Shingle, 251 F. 2d 801, 116 USPQ 32, 37-38 (9th Cir. 1957).

VIII

PLAINTIFFS DID NOT INFRINGE

In Reachi v. Edmond, 277 F. 2d 850, 125 USPQ 265, 266-267 (9th Cir. 1960), this Court set forth the test of infringement:

> " . . . if, in the eye of an ordinary observer, giving such attention as a purchaser usually gives, two designs are substantially the same, if the resemblance is such as to deceive such an observer, inducing him to purchase one supposing it to be the other, the first one patented is infringed by the other."
>
> * * * * *
>
> "Although servile imitation is not required to constitute infringement, a patentee who claims only the design 'as shown' is limited to substantially the form disclosed in the drawing. * * * The impression created by the design must be derived from the thing patented, and not by the selection of one or

more features of which the observer particularly approves."

Accord: Sunbeam Lighting Co. v. Pacific Associated Lighting, 328 F. 2d 300, 140 USPQ 512, 513-514 (9th Cir. 1964); Amerock Corp. v. Aubrey Hardware Mfg., Inc., 275 F. 2d 346, 124 USPQ 439, 440 (7th Cir. 1960); E. H. Sheldon & Co. v. Miller Office Supply Co., Inc., 188 F. Supp. 67, 127 USPQ 119, 120 (S. D. Ohio 1960); Eileen Mills Co., Inc. v. Ojay Mills, Inc., 188 F. Supp. 138, 127 USPQ 370, 373 (S. D. N. Y. 1960); 1 Walker on Patents (Deller's Edition), § 137, page 431. Note that § 1503. 1 of the Manual of Patent Examining Procedure expressly provides that the description may contain a "dominant feature" clause and, likewise, may emphasize some specific point of novelty as a "characteristic" or an "important" or an "essential" part of the design. McPhee contained no such clause. Thus, the patent covered the totality of elements and there was no "essential" element, "gist" or "heart" of the invention. Cf. Aro v. Convertible Top, 365 U. S. 336, 128 USPQ 354, 358-359 (1961).

Every element of the design was therefore essential. Amerock v. Aubrey, 275 F. 2d 346, 124 USPQ 439, 440 (7th Cir. 1960). Yet defendants' expert -- hardly an "ordinary observer" -- used only three basic criteria, of which he particularly approved, for his comparison: (1) size, (2) silhouette, and (3) pinched-in waistline (Rep. Tr. 19). He ignored the following admitted differences:

(1) that Defts. Ex. C, labelled in Pltfs. Ex. 10 as

"Accused Payne Mod. #542", was "closer to a ball" than the device labelled "Actual Pourer Manufactured by Anchor" (Rep. Tr. 39);

(2) that Defts. Ex. C had an angular bead around the ball, as distinguished from McPhee's horizontal bead (Rep. Tr. 41);

(3) that the pouring spout of Defts. Ex. C extended farther above the body than the patented device (Rep. Tr. 41); and

(4) that Pltfs. Ex. C had a bell-shaped or curvilinear skirt while the patent showed a skirt with straight sides (Rep. Tr. 42-43).

Plaintiffs submit that these differences, which also distinguish Defts. Ex. B, are such that they would not deceive an ordinary observer, inducing him to purchase either of the Payne models supposing it to be the McPhee design. In any event, the burden of proof was on the defendants, 3 Walker on Patents (Deller's Edition), § 741, pp. 2045-2046, and they failed to call a single "ordinary observer", or anyone else, who had purchased a Payne device thinking it was a McPhee device. Thus, the evidence does not support the findings of infringement in Findings of Fact 25, 26 and 27.

For the above reasons, plaintiffs ask that the judgment holding the patent valid and infringed be reversed.

Respectfully submitted,

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Attorneys for Appellants.

CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

/s/ Thomas P. Mahoney
THOMAS P. MAHONEY

No. 21170

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

PAYNE METAL ENTERPRISES, LIMITED, a corporation, and PAYNE MANUFACTURING COMPANY, LIMITED, a corporation,

Appellants,

vs.

JAMES E. MCPHEE, and ANCHOR PRODUCTS, INC., a corporation,

Appellees.

APPELLEES' BRIEF.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

No. 21170

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Appellees.

APPELLEES' BRIEF.

This is an appeal from the final judgment of the United States District Court, Central District of California, holding the McPhee design patent 176,986 to be valid and infringed. Throughout this brief, all references herein to TR. shall mean the "Reporter's Transcript of Proceedings, two volumes"; Cl. Tr. shall mean the "Clerk's Transcript, one volume"; O.B. shall mean "Appellants' Opening Brief"; PX. shall mean "Plaintiffs-Appellants' Exhibits"; and DX. shall mean "Defendants-Appellees' Exhibits".

Jurisdiction.

This being an action for patent infringement on Plaintiffs' complaint for declaratory relief, the District Court had jurisdiction under 28 U.S.C. §§ 1338(a) and 2201.

This Court has jurisdiction under 28 U.S.C. § 1291.

Summary of the Argument.

United States Design Patent No. Des. 176,986, issued on February 28, 1956, to James E. McPhee is a new, original and ornamental design of a "Liquor Pourer".

This patent meets the test of the patent laws and is invention within the meaning of Section 171 of Title 35 U.S.C. The subject matter of the design patent in suit is not identically disclosed or described by any prior art references within the meaning of Section 102, Title 35 U.S.C., and the differences between the subject matter patented by James E. McPhee and the prior art is not such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art, within the meaning of Section 103, Title 35 U.S.C. When the design of the patent in suit as a whole is tested against the prior art on the issue of novelty and against the Plaintiffs-Appellants' devices held to infringe the patent in suit, it becomes obvious that Appellants' devices do not follow the teachings of the prior art, but are a colorful imitation and, hence an infringement of the McPhee patented design.

There was a need for the patented device and it has enjoyed considerable commercial success. The design of the patent was not dictated by function and there is no invalidating double patenting involved.

ARGUMENT.

I.

THE COURT'S FINDINGS OF FACT ARE FULLY SUPPORTED BY THE RECORD AND ARE NOT CLEARLY ERRONEOUS.

The principal thrust of Appellants' brief is their challenge to the findings of the District Court. Appellants say the Trial Court is in error by adopting findings prepared by the Defendants-Appellees, the prevailing parties in the Court below (O. B. 11). This resolves itself into one issue which is:

> Are the Findings of Fact supported by the evidence before the Trial Court?

The Plaintiffs-Appellants are really asking this Court to substitute its judgment for that of the Trial Court which cannot be done in the absence of a holding that the Trial Court's findings are "clearly erroneous". Rule 52(a) Federal Rules of Civil Procedure, 28 USCA, *Monroe Auto Equipment Co. v. Superior Industries*, (9 Cir., 1964) 332 F. 2d 473, 477, 485.

Quoting from *Armour & Co. v. Wilson & Co.*, (7 Cir., 1960) 274 F. 2d 143, this Court said:

> ". . . (T)he rules governing the trial of patent cases are no different than in other types of civil litigation, and further, that the scope of our review on appeal follows the same pattern. We look at the findings of fact as to invention in the way that such factual determinations are generally reviewed. We examine the standard of invention applied to these facts as a question of law, as we have done in other areas. . . ."

Pressteel Co. v. Halo Lighting Products Inc., (9 Cir., 1963), 314 F. 2d 695, 697-698.

It is the responsibility of this Court ". . . to look at the evidence most favorable to the appellee . . ." and ". . . ask whether there was sufficient and substantial evidence, which, though disputed, if believed, was sufficient to support the findings . . ." and, further, to ". . . assume . . . that any findings signed by a trial judge do reflect his thinking" and we ". . . must also presume they accurately reflect his thinking." *Continental Connector Corporation v. Houston Fearless Corporation*, (9 Cir., 1965) 350 F. 2d 183, 189.

The fact that the District Court did not write a memorandum opinion which could supplement the findings and conclusions (O. B. 10) and adopted Appellees' findings and conclusions without change (O. B. 11) which were favorable to the prevailing Appellees (O. B. 13), is of no significance unless the findings are "clearly erroneous". Rule 52(a) FRCP, Title 28 U.S.C. *Continental Connector Corp. v. Houston Fearless Corp., supra,* 350 F. 2d 183, 187.

> ". . . (F)indings, though not the product of the workings of the district judge's mind, are formally his; they are not to be rejected out-of-hand, and they will stand if supported by evidence." *United States v. El Paso Natural Gas Co.,* (1964) 376 U.S. 651, 656, 84 S. Ct. 1044, 1047; *Nyyssonen v. Bendix,* (1 Cir., 1965) 342 F. 2d 531, 532; *Rooted Hair Inc. v. Ideal Toy Corp.,* (2 Cir., 1964) 329 F. 2d 761, 765; *Edward Valves, Inc. v. Cameron Iron Works,* (5 Cir., 1961) 289 F. 2d 355, 356.

II.

THE MC PHEE DESIGN PATENT 176,986 IS VALID.

A. The McPhee Design Patent No. 176,986 Is New, Original and Ornamental.

Whether in design, the McPhee liquor pourer is new, original and ornamental within the meaning of the statute, Title 35 U.S.C. §171, depends upon:

(1) Does it ". . . produce a new impression upon the eye", *Patriarca Mfg., Inc. v. Sosnick,* (9 Cir., 1960) 278 F. 2d 389, 391 (and the cases cited), *Falcon Industries, Inc. v. R. S. Herbert Co., Inc.,* (DC NY 1955) 128 F. Supp. 204, 210, cited with approval by this Court in *Robert W. Brown & Co. v. Leonard DeBell,* (9 Cir., 1957) 243 F. 2d 200, 203; and

(2) Is it new and original in the sense that the *art* did not know of such a design? Title 35 U.S.C. §103; *Walker v. General Motors Corp.,* (9 Cir., 1966) 362 F. 2d 56, 58-60; *Alladin Plastics, Inc. v. Jerrold Stephan Co.,* (9 Cir., 1966) 362 F. 2d 532, 533; *Falcon v. Herbert, supra,* 128 F. Supp. 204, 210.

The test as to both of these requirements, according to the Supreme Court, is that ". . . *the design as a whole, and not any part of it as a part,* . . . is to be tested . . . as to novelty and infringement." (Emphasis added). *Dobson v. Dornan,* (1886) 118 U.S. 10, 15, 6 S. Ct. 946, 948, 30 L. Ed. 63; *Gorham Mfg. Co. v. White,* (1872) 14 Wall. 511, 526-527, 20 L. Ed. 731, 737.

Defendants-Appellees' expert, Channing Gilson, testified that he ". . . was looking at it more as a *total* shape versus parts." [TR. 26].

The art segment of this question (section (2) above), is discussed in detail *ante* under the heading "THE PRIOR ART", at pages 10-25; thus we now confine ourselves to a discussion of part (1) of the question, which stated positively is ". . . that proverbial subjective test which somewhat enlists the eye of the beholder." *Falcon v. Herbert, supra,* 128 F. Supp. 204, 210.

(The Eye Test)

This Court states the "eye test" rule in the following language:

> "To be patentable, the design, viewed as a whole, must produce a new impression upon the eye." *Patriarca Mfg., Inc. v. Sosnick, supra,* 278 F. 2d 389, 391.
>
> "Patentability exists if the design looked at as a whole (le tout ensemble) gives a *pleasing* impression." *Laskowitz v. Marie Designer, Inc.,* (DC Cal., 1954) 119 F. Supp. 541, 544; *Bliss v. Gotham,* (9 Cir., 1963) 316 F. 2d 848, 850; *Blisscraft of Hollywood v. United Plastics Company,* (2 Cir., 1961) 294 F. 2d 694, 696; *Burgess Vibrocrafters, Inc. v. Atkins Industries,* (7 Cir., 1953) 204 F. 2d 311; *Hygienic Specialties Co. v. Salzman,* (2 Cir., 1962) 302 F. 2d 614, 618.

Even though the test of patentability in a design is that it is to be viewed as a whole (*Dobson v. Dornan, supra,* 118 U.S. 10, 15), we must recognize that the McPhee '986 design does, like most pleasing designs,

have a predominant feature, which is the "pinched-in *waistline*" [Tr. 19]. It is this feature which makes the design unique. See Exhibit F[1] Appendix this brief.

Defendants-Appellees' expert witness testified as follows:

> "A. I had in mind that to identify a product properly, not from my point of view as a technician, but in the sense that the public looks at things in an abstract way, they are *not* picking a little part in different angles and what not, they are *seeing the total effect*, the mass, the proportions, *the key to the design,* which I say in this case *is the waist line which is entirely new* in all these liquor pourers, so it sees this one big distinctive feature, the total attractive proportions and the neatness of the design; it is appealing." [TR. 66-67].

On cross-examination by Appellants' counsel, Mr. Gilson testified as follows:

> "Q. And actually when the purchasing public sees the device, it doesn't see only the silhouette, it sees all the surface detail and parts of the device

---

[1]Exhibit F [Tr. 20-23] is reproduced as a fold-out in the appendix. The only change (except reduction of size) that has been made in this Exhibit is in the placements of the letters "X" and "Y" to facilitate reading as here reproduced (the Exhibit has been turned on its axis 90 degrees), and the additional designation of the "McPhee '986" device and the "Payne' device."

In Exhibit F, Figure 1 is a silhouette designed to represent an average side view; Figure 2 is looking at the device "toward the spout"; and Figure 3 is a "top view looking straight down on the device." [Tr. 21].

Where Mr. Gilson discusses Exhibit F on page 21, lines 2 and 3, his statement should be corrected to read—X happens to be the *plaintiffs'* product and Y is the McPhee design—, substituting the word "plaintiffs' " for the word "defendants".

and the over-all configuration, isn't that true? A. Now, I don't think it is true, in that most of the public or average people or myself, when I see an object for the first time I don't see all these minutiae, *I see the general shape; the silhouette becomes very important in the many, many views that a public is likely to see in the product for the first time or the second time.*" [TR. 58].

On re-direct examination, he later said:

"Q. Mr. Gilson, now going back to the impression that the public gets for a moment, in your opinion, is the public interested in whether the skirt may be bulbous or whether it is a ball or whether it is round or it is an ovoid when they are purchasing something? A. I don't think they are. I think they have an image of what they expect, and the quality in the image is what they are after." [TR. 65-66].

See also Mr. Gilson's testimony [TR. 38-46].

"'. . . Purchasers do not always see the goods in juxtaposition. They rely upon memory and vague impressions.' * * *"

Albert Dickinson Co. v. Mellos Peanut Co., (7 Cir. 1950) 179 F. 2d 265, 270.

Appellants' expert also feels that the designs must be viewed as a whole [TR 102].

B. Statutory Provision Relating to Design Patents.

Title 35 U.S.C. §171 provides:

"Whoever invents any new, original and ornamental design for an article of manufacture may obtain a patent therefor, subject to the conditions and requirements of this title.

> "The provisions of this title relating to patents for inventions shall apply to patents for designs, except as otherwise provided."

This provision subjects a design patent to all the tests to which mechanical patents are subjected. *Brown v. DeBell,* (9 Cir., 1957) 243 F. 2d 200, 202. However, ". . . the statute contemplates appearance rather than utility." *Thabet Manufacturing Company v. Kool Vent Metal Awning Corporation,* (6 Cir., 1955) 226 F. 2d 207, 211-212; *Gorham v. White, supra,* 14 Wall. 511; *Brown v. DeBell, supra,* 243 F. 2d 200, 202.

C. Presumption of Validity.

> "A patent shall be presumed valid. . . . The burden of establishing invalidity of the patent . . . shall rest on a party asserting it . . .". Title 35 U.S.C. §282.
>
> ". . . The Presumption is predicated upon the *expertness* of the Patent Office acting within its specific field, and can be overcome only by clear and convincing proof. The burden of proof in such cases is upon the party attacking the patent, and reasonable doubts must be resolved in favor of validity . . ." (emphasis added). *Moon v. Cabot Shops, Inc.,* (9 Cir., 1959) 270 F. 2d 539, 541, cert. den. 361 U.S. 965, 80 S. Ct. 596, 4 L. Ed. 2d 546; *Hayes Spray Gun Co. v. E. C. Brown Co.,* (9 Cir., 1961) 291 F. 2d 319, 322; *Neff v. Cohu,* (9 Cir., 1961) 298 F. 2d 82, 86; *Hunt Tool Co. v. Lawrence,* (5 Cir., 1957) 242 F. 2d 347, 351, cert. den. 354 U.S. 910, 77 S. Ct. 1296, 1 L. Ed. 2d 1428; *Jeoffroy Mfg., Inc. v. Graham,*

(5 Cir., 1955) 219 F. 2d 511, 519, cert. den. 347 U.S. 920, 74 S. Ct. 515, 98 L. Ed. 1075, reh. den. 347 U.S. 936; *Otto v. Koppers Company, Inc.,* (4 Cir., 1957) 246 F. 2d 789, 800-801, cert. den. 355 U.S. 939, 78 S. Ct. 427, 2 L. Ed. 2d 420; *Diamond Rubber Co. of New York v. Consolidated Rubber Tire Co.,* 220 U.S. 428, 31 S. Ct. 444, 55 L. Ed. 527; *Ric-Wil Co. v. E. B. Kaiser Co.,* (7 Cir., 1950) 179 F. 2d 401, 404, cert. den. 339 U.S. 958, 70 S. Ct. 981, 94 L. Ed. 1369.

D. The Prior Art—Findings 14, 15, 16, 18, 19 and 20.

1. Presumption of Validity Is Strengthened by Patent Office Consideration of the Most Pertinent Prior Art.

It has long been recognized that the presumption of validity is strengthened by the Patent Office consideration of the most pertinent prior art. This principle, of course, goes hand-in-hand with the recognition of the expertise of the Patent Office in acting upon a specific field. *Moon v. Cabot Shops, Inc., supra,* 270 F. 2d 539, 541; *Cantrell v. Wallich,* (1886) 117 U.S. 689.

2. The Patent Office Did Consider the Most Pertinent Prior Art—Findings 14-19.

In Appellants' complaint filed January 29, 1964 [Cl. Tr. 2, O. B. 1], they cited seventeen foreign and domestic patents and publications to be prior art to the design patent in suit [DX. A; Cl. Tr. 5]. In their proposed Findings of Fact, Conclusions of Law, which accompanied their Motion for Summary Judgment, lodged May 7, 1964, they asserted only ten of these patents as being pertinent [Cl. Tr. 84-89]. In the Appellants' Pre-Trial statement filed just prior to Trial,

they again asserted as pertinent prior art, the original seventeen foreign and domestic patents and publications [Cl. Tr. 155]. At the time of Trial, Appellants had limited their Prior Art Book [PX. 3] to only nine prior art patents [TR. 49-50], but actually *relied on only three* of these nine references during the Trial, to wit, McPhee No. '290 [PX. 3-A], Ferguson Australian Patent 9658 [PX. 3-D], and Maloney Patent '051 [PX. 3-B, TR. 49, 51, 52, 59, 60, 86-89, 113-115]. The only publication relied upon by Appellants at the time of the Trial was page 74 of "House Furnishing Review" for May, 1949 [PX. 4, TR. 90-91, 114].

From the foregoing, we must assume that Appellants considered only these references [PX. 3-A, 3-B, 3-D and 4] to be the most pertinent. This must be true because Appellants left unchallenged the first sentence of Finding 15, which recites that McPhee '290, Ferguson 9658, and "House Furnishing Review", "were also considered by plaintiffs (appellants) to be *among* the most pertinent prior art references" [Cl. Tr. 180], and do not challenge any part of Finding 17 which lists the twelve remaining references cited by Appellants, and recites in part: "These . . . prior art patents were not cited . . . and none is a better reference than those cited . . ." [Cl. Tr. 180-181, O. B. 6].

The two patents and the publication which are the subject of the first sentence of Finding 15 [Cl. Tr. 180] were before the Patent Office prior to the issuance of the McPhee patent in suit [DX. A], and the patent in suit was considered by the Patent Office to be inventive over these references and the July 6, 1953 publication in "Giftwares" at page 86 [Exh. A]. The

question then becomes, was the uncited Maloney '051 patent [PX. 3-B], discussed below, "*most pertinent*"?

a. *The Maloney Patent '051 Was Not a Cited Reference Before the Patent Office—Finding 16.*

The Maloney '051 patent [PX. 3-B] was not cited as a prior art reference during the prosecution of the application which issued as the patent in suit. The question of whether or not the failure of the Patent Office to consider the Maloney '051 patent during the prosecution of the McPhee was fatal to McPhee is best answered by an oft quoted passage from an opinion of the Court of Appeals for the 4th Circuit, which is:

> ". . . Astute and enterprising attorneys can always find references not of record in the Patent Office, but *if they do not involve some substantial element* in the defense of anticipation which was not considered by the Patent Office, the failure to make them record references cannot weaken the statutory presumption". (emphasis added). *Otto v. Koppers Company, Inc., supra*, 246 F. 2d 789, 801, cert. den. 355 U.S. 939.

and by the District Court in Georgia where it held:

> ". . . Defendants' argument that the Patent Office did not consider Adams I is based upon the fact that the Patent Office did not cite that patent. This fact does not carry defendants' burden of proof. In the case of Artmoore Co. v. Dayless Mfg. Co., 7 Cir., 1953, 208 F.2d 1, 4, it was said:
>
> > 'It has been held, and we think with logic, that it is as reasonable to conclude that *a prior art patent not cited was considered and cast aside* because not pertinent, as to conclude

that it was inadvertently overlooked [citing cases].'

"Furthermore, references not of record in the Patent Office cannot weaken the statutory presumption if they do not involve some substantial element in the defense of anticipation which was not considered by the Patent Office". (emphasis added). *Adams v. Columbus Mfg. Co.*, (D.C. Ga. 1960), 180 F. Supp. 921, 930.

b. *Maloney Patent No. 2,275,051 Does Not Involve Any Substantial Element That Was Not Considered by the Patent Office—Findings 14 and 16.*

An examination of the patent in suit [DX. A] and of Appellees' commercial structures [DX. G] made under the teaching of McPhee '986, in suit, readily show that the most distinctive features of the patented design are in the words of Mr. Gilson:

(1) The "shapely" *body* section [TR. 26, 30 & 37] with a spout;

(2) A "pinched-in *waistline*" [TR. 19]; and

(3) A *skirt* that "flows freely away from the body" [TR. 27].

These features are not present in the Maloney '051 patent.

Maloney describes his device in part as follows:

". . . The upper portion U comprises a *cap* member 11 of substantially *cylindrical shape* and . . . a downwardly extending annular skirt portion 12, the upper end of skirt portion 12 being preferably provided with a threaded portion 13 . . ." [TR. 91-92, PX. 3-B, column 2, lines 23-29].

So we see, Maloney calls his entire cap 11, a skirt.

Appellants' expert, Mr. Abraham Grossman, had this to say on *direct* examination about the Maloney patent:

> "Q. I now direct your attention to the patent Exhibit 3-B, which is the '051 Maloney patent, . . . Do you find a skirt in the device shown in that patent? A. *If the body* of that cap *can be considered* a skirt, I don't know. There is a dome portion with a lower straight portion." [TR. 87].

On *cross-examination,* Mr. Grossman testified:

> "Q. Now, there is *no waist* shown on the device shown in Exhibit 3-B (Maloney '051), is there? A. No, there is not.
>
> Q. That is an entirely *straight skirt?* A. It is a *cylindrical shape.*" [TR. 112].
>
> . . .
>
> "Q. And I direct your attention to figure 1 of 3-B (Maloney '051) and comparing the cap of the bottle shown in figure 1 with (the patent in suit) Exhibit A, I will ask you this question, is there any similarity between the appearance of the cap of the bottle as shown in figure 1 and the Exhibit A? A. Not in shape.
>
> Q. There is not, in shape or design? A. No. The only similarity is that it has a spout" [TR. 115].

Thus, it would appear, according to the patentee, Maloney, that his whole cap is a skirt (not only the portion below the threads), and as such, has no body portion; or, alternatively, there is the view of Appellants' expert, Mr. Grossman, who was of the opinion that the cap of the Maloney device was in fact a body

portion in its entirety [TR. 87]. In any event, assuming the Maloney device to have either a cylindrical body or skirt [TR. 87, 112] it does not have two essential features of the McPhee '986 design which are:

(1) A "pinched-in *waistline*"; nor

(2) Does it have a *skirt* that "flows freely away from the body."

c. *The Rule That the Presumption of Validity Is Overthrown When Even One Prior Art Reference Was Not Considered by the Patent Office Is Not Applicable When Considering the Less Pertinent Maloney '051 Patent—Finding 16.*

The Appellees are mindful of the holding by this Court in many patent cases, which is as follows:

> "Generally, the action of the Patent Office in allowing the patent creates a presumption of validity. However, even one prior art reference which has not been considered by the Patent Office may overthrow this presumption. [citing cases.] When the *most pertinent* art has not been brought to the attention of the administrative body the presumption is largely dissipated. [citing cases.]" (emphasis added). *Jaybee Mfg. Corp. v. Ajax Hardware Mfg. Corp.*, (9 Cir., 1961) 287 F. 2d 228, 229; *Pressteel Company v. Halo Lighting Products, Inc., supra,* 314 F. 2d 695, 697; and *Monroe Auto Equipment Company v. Superior Industries, supra,* 332 F. 2d 473, 481.

As it states, the foregoing rule followed by this Court is only applicable if the uncited prior art reference is *most pertinent*. Certainly the uncited Maloney

'051 patent [PX. 3-B] to which Appellants' expert refers while comparing it with the patent in suit [DX. A] saying: "*The only similarity* (between the two) *is that it* (Maloney) *has a spout* [TR. 115]"; cannot be considered *the most pertinent* prior art in the sense that it anticipates or suggests the design of the patent in suit.

Maloney '051 [PX. 3-B] *has nothing in common with the patent in suit except the "spout"* [TR. 115], *cf. Monroe Auto Equipment Co. v. Superior Industries, supra,* 332 F. 2d 473.

3. Not One of the Patents or Publications Relied on by the Appellants as a Prior Art Reference Is an Anticipation of the Design of the McPhee Patent in Suit—Findings 14-19.

a. *The McPhee '290 Patent.*

On direct examination by Mr. Mahoney, Appellants' counsel, their expert, Mr. Grossman, had this to say about the McPhee '290 patent:

> "Q. Mr. Grossman, I hand you Exhibit 3, which is an art book containing various patents, and I direct your attention to 3-A, which is McPhee Patent 2,667,290, and I ask you if you can draw any comparison between the showing of a pourer in figure 1 and the showing of the pourer in the same attitude in figure 3 of the '986 patent in issue here, defendants' Exhibit A."
>
> * * * *
>
> "A. Yes. A comparison between Exhibit 3-A and Exhibit A shows that in Exhibit 3-A there is *no skirt* attached to the upper portion of the pourer. . . ." [TR. 86].

This patent when compared with the design of the patent in suit [DX. A] shows that it *lacks* two very essential features of the McPhee design which are:

(1) The "pinched-in *waistline*"; and

(2) The *shirt* that "flows freely away from the *body.*" [PX. 3-A and DX. A].

b. *The Ferguson 9658 Australian Patent [PX. 3-D].*

On cross-examination by Mr. Mahoney, Appellees' expert was asked:

> "Q. Now, do you find a waist line in the Australian device? A. No, I don't find a waist line." [TR. 59].

And in response to a similar question Mr. Gilson testified:

> "A. I think when we would look at these designs, like the public would as a whole, that the waist in one case is at the midpoint, whereas in a device like this (indicating PX 3-D) there is no such thing as a waist, any more than a basketball has a waistline." [TR. 60].

and

> "The Witness: A waist line is like my waist. It is at the midpart of my body, approximately."
>
> * * * *
>
> "A Well, I think as a normal person understands the waist line of a woman or of a man, it is that area that tapers from the body. And this [DX A and G] is obviously a waist line, I think to an average person it would be a waist line." [TR. 61].

A comparison of the Ferguson 9658 Australian patent drawing [PX. 3-D], and the patent in suit [DX. A] readily show that even if you do call the part 14 in figure 1 of Ferguson, a "skirt" instead of a "flange" as defined by the patentee [PX. 3-D, column 3, lines 28-34, TR. 113], the Ferguson disclosure *lacks* two very important elements which are present in the McPhee '986 design in suit. They are:

(1) The "pinched-in waistline"; and

(2) The *skirt* that "flows freely away from the *body.*"

c. *House Furnishing Review, Page 74* [*PX. 4*].

Mr. Grossman (Appellants' expert) testified on direct examination that there was ". . . a similarity in the general shape of the upper portion between Exhibit 4 and the upper portion of the item of Exhibit A (the body portion, McPhee '986)" and, ". . . There is, however, an *added member* (skirt) that seems to be connected (to the body member of McPhee '986), but the general shape of the pourer itself resembles the upper portion of Exhibit A." [TR. 90].

Page 74 of the "House Furnishing Review" for May, 1949, was before the Patent Office Examiner while the patent in suit was pending [DX. A, TR. 114].

Like McPhee's '290 [PX. 3-A], PX. 4 when compared with the patent in suit [DX. A], *lacks:*

(1) The "*pinched-in waistline*"; and

(2) The skirt that "flows freely away from the *body.*"

d. *Appellants' Exhibit 13, the Dome Pourer— Finding 18.*

Although Appellants never offered their Exhibit 13 in evidence during the Trial, there is some testimony on this device which is: that it is a device where "there is no body" and you can find *no* ". . . separate *body* portion . . . with a *waist* and a *skirt* . . ." [TR. 272-273].

A comparison between the design disclosed in the patent in suit [DX. A] and Appellants' Exhibit 13 readily show that Exhibit 13 *lacks:*

(1) A "pinched-in *waist line;*" and

(2) A *skirt* that "flows freely away from the *body.*" [DX. A and PX. 13].

e. *The Maloney '051 Patent.*

See paragraph 2b. above entitled "Maloney Patent No. 2,275,051, does not involve any substantial element that was not considered by the Patent Office", pages 13-16 of this brief.

4. None of the Patents or Publications Relied Upon by the Appellants, Including the Device of Exhibit 13, Alone or in Combination, Teaches or Suggests the Design of the Patent in Suit to the Mind of a Person Having Ordinary Skill in the Art—Findings 14-20.

From paragraph 2b. above (this brief, pages 13-16) we find that when compared with the patent in suit [DX. A], the Maloney '051 patent [PX. 3-B] *does not have* the "pinched-in waistline" *nor does it have* a skirt that "flows freely away from the body" [TR. 87, 112 and 115].

From paragraph 3, entitled "Not one of the patents or publications relied on by the Appellants as a prior art reference is an anticipation of the design of the McPhee patent in suit", pages 16-19, this brief, we find: McPhee '290 patent *lacks* any sort of a *"skirt"*, let alone one that "flows freely away from the body," and that it has *no* "pinched-in *waistline*" from which a skirt can flow, both featured in the design of the patent in suit [PX. 3-A, DX. A and TR. 86].

The Australian patent to Ferguson, 9658, when compared with Exhibit A, *does not have* a "pinched-in waistline" and a freely flowing *skirt* extending from the *body*. [TR 59-61, PX. 3-D, Column 3, lines 28-34; TR. 113-114].

From the publication found at page 74 of the "House Furnishing Review" [PX. 4], when comparing it with Exhibit A, we find that like the McPhee '290 patent [PX. 3-A], it, too, *lacks* the features of the patented design [DX. A], which are the *"pinched-in waistline"* and the *freely flowing skirt* extending from the body portion [TR. 90]. *Exhibit 13 also lacks these same features.* It will be recalled this is the device which has no separate body portion with a skirt, to say nothing of the "pinched-in" waistline [TR. 272-273].

So we can readily see from an examination of all of the prior art which Appellants and the Patent Office considered to be the most pertinent, that there was no teaching or suggestion whatsoever, to those skilled in the art, from any or all of the references for a design which has: a body section with an attached spout; a "pinched-in *waistline*"; and, a *skirt* that "flows freely away from the body" [TR. 19 and 27] [DX. A, PX. 3].

5. Where the Record Discloses the Patent Office Considered the Most Pertinent Prior Art the Presumption of Validity Is Strengthened—Findings 14-20.

The patent in suit [DX. A] best shows the consideration given by the Patent Office to the most pertinent prior art, McPhee '290 [PX. 3-A], Ferguson Australian Patent 9658 [PX. 3-D], and the publication found in "House Furnishing Review" [PX. 4], plus the other cited publication, "Giftwares", which Appellants did not offer at the Trial [DX. A], and illustrates the thoroughness in which the Patent Office gave consideration to the invention of the patent in suit insofar as distinguishing it from the cited references [DX. A, TR. 86-92, 110-115, 272-273, Cl. Tr. 5 and 155].

As we have seen above, Maloney '051 [PX. 3-B] adds nothing helpful to the prior art to invalidate the patent in suit; hence the Patent Office did consider "most pertinent" prior art as stated in Finding 14.

> ". . . the presumption of a patent's validity becomes all the stronger when the Patent Office has considered the most pertinent references before issuing the patent."
>
> *Neff Instrument Corp. v. Cohu, supra*, 298 F. 2d 82, 86-87.
>
> "Our review of the record convinces us that these findings are not clearly erroneous. In our opinion, none of the prior art embraces, in substantial respects, the combination of features which lend novelty and invention to the design in question."
>
> *Brown v. DeBell, supra*, 243 F. 2d 200, 202.

". . . Other factors strongly influencing and, we think, reinforcing our conclusion as to the validity of 798 are: (1) that presumption of validity which attends the grant of a patent by the Patent Office where, as here, it appears to have *fully considered and distinguished the very prior art patents here principally relied upon as anticipation,* Southern States Equip. Corp. v. USCO Power Equip. Corp., supra; (2) the rule that the burden of proof of invalidity is on the party seeking to upset a patent's prima facie validity from issuance, and that any reasonable doubt will be resolved against him, . . .".

Jeoffroy Mfg., Inc. v. Graham, supra, 219 F. 2d 511, 519;

Hayes Spray Gun Co. v. E. C. Brown Co., supra, 291 F. 2d 319, 322.

". . . It is to be observed that the action of the Patent Office as shown in the file wrapper, discloses three references cited as illustrating the state of the prior art; and since the Bugg application was granted, it is obvious that the Office regarded the Bugg disclosure as patentable over each of the references. Consideration of the patents so listed by the Office here in evidence, vindicates the action taken."

Falcon v. Herbert, supra, 128 F. Supp. 204, 210.

6. Citations of an Inordinate Number of Patents and Publications Strengthens the Presumption of Validity —Finding 20.

As discussed above, when Appellants filed their complaint in 1964, they cited seventeen foreign and domestic patents and publications as prior art [Cl. Tr. 5] which, at the time they made their Motion for Summary Judgment, was reduced to ten [Cl. Tr. 84-89]. When they filed their Pre-Trial Statement, they again asserted the original seventeen, but only presented nine in their prior art book [PX. 3] at the time of Trial, and ultimately only relied upon three of these patents and but one publication [PX. 3, 3-A, 3-B, 3-D and 4], to support their contention that Appellees' invention is lacking in novelty and was obvious to one skilled in the art. It has long been recognized that the citation of an inordinate number of patents strengthens the presumption of validity.

On this subject, the words of the Court of Appeals for the 4th Circuit are most appropriate:

> "Defendant has cited 21 patents as basis for its contention that complainants' invention is lacking in novelty; and this in itself is evidence of the weakness of the contention. Such a citation of so many prior patents almost always means either that none of them is in point and that the patentee has brought together for the purpose of his invention devices to be found in prior patents of different character or that there have been prior attempts to solve the problem with which he was confronted which have not met with success [citing cases]. Patents for useful inventions ought not be invalidated and held for naught because of such

excursions into the boneyard of failures and abandoned experiments".

Reynolds v. Whitin Machine Works, (4 Cir., 1948) 167 F. 2d 78, 83-84, cert. den. 334 U.S. 844, 68 S. Ct. 1513, 92 L. Ed. 1768.

Where nineteen patents were cited as being anticipatory, the District Court for the Northern District of California had this to say:

"In their answer, defendants alleged 36 patents and publications to be anticipatory of the Behr patents. At the trial, upon prodding by plaintiffs' counsel, the number was reduced to 19 and the evidence limited thereto. Even so, this is a large number of anticipatory patents and publications upon which to rest this defense. In itself this is persuasive of the futility of prior attempts to solve the problem [citing cases].

'Knowledge after the event is always easy, and problems once solved present no difficulties, indeed may be represented as never having had any . . ..' said Mr. Justice McKenna in Diamond Rubber Co. v. Consolidated Rubber Tire Co., 220 U.S. 428, 435; 31 S.Ct. 444, 447; 55 L.Ed. 527".

Vegetable Oil Products Co. v. Dorward & Sons, (D.C. N.D. Cal. 1943) 53 F. Supp. 281, 285.

From the foregoing discussion of the prior art, it is evident that the Court's Findings of Fact 14, 15, 16, 18, 19 and 20, and Conclusions of Law 3, 4, 5 and 7 are fully supported by the record and are not "clearly erroneous". Rule 52(a) FRCP. The design of the McPhee patent in suit '986 was and is valid, and would not have been obvious at the time the invention was

made to a person having ordinary skill in the art to which the subject matter pertains, Title 35 U.S.C. §103, and the patent in suit was not anticipated by the prior art and fully satisfies the requirements of Title 35 U.S.C §§102(a) (b) and (f).

E. The Presumption of Validity Is Further Strengthened by Appellants' Imitation of the Patent in Suit—Findings 25 and 26.

> ". . . (T)hat defendant's alleged infringing structure was designed *in the main* in conformity with the disclosures of the patents in suit can hardly be doubted. The prior art upon which defendant now lavishes its praise was apparently permitted to lie dormant until the exigency, created by a suit for infringement, required its resurrection. *Defendant's imitation of the patent structure is another indication of invention.* Kurtz et al v. Belle Hat Lining Company, Inc., 2 Cir., 280 F. 277, 281. Fones v. American Specialty Co., D.C., 38 F.2d 639, 642; Gairing Tool Co. v. Eclipse Interchangeable Counterbore Co., 6 Cir., 48 F.2d 73, 75; Sandy MacGregor Co. et al v. Vaco Grip Co., 6 Cir., 2 F.2d 655, 656" (Emphasis added).
>
> *Ric-Wil Co. v. E. B. Kaiser Co., supra,* 179 F. 2d 401, 404, cert. den. 339 U.S. 958.

A side by side comparison of the Appellants' commercial structures [DX. B, C and PX. 9], with figures 1 through 5 of Appellees' patent in suit [DX. A, and F] can, when considered in light of the credible testimony before the Trial Court, leave no doubt that

Appellants have imitated the device described in the patent in suit [TR. 20-23, 38-46, 58-62, 65-68].

This principle has best been stated and oft quoted from the language of the Court of Appeals for the 2nd Circuit in *Kurtz v. Belle Hat Lining Co.,* (C.A. 2) 280 Fed. 277, 281:

> "The imitation of a thing patented by a defendant, who denies invention, has often been regarded, . . . as conclusive evidence of what the defendant thinks of the patent, and persuasive of what the rest of the world ought to think."

And from the language of the Court of Appeals for the 4th Circuit:

> "Revolutions, even in one branch of an industry, are infrequently the product of old ideas. particularly in a field in which highly trained and skillful engineers were working, on various approaches, to achieve the result, the imitators can hardly be heard to say they knew all the while that the answer lay in the concept which, upon its disclosure, made their own work obsolete. This Court, under these circumstances, cannot find the concept wanting in inventive novelty".
>
> *Otto v. Koppers Company, Inc., supra,* 246 F. 2d 789, 800, cert. den. 355 U.S. 939, 78 S. Ct. 427, 2 L. Ed. 2d 420.

For a further discussion on this subject, see III, entitled "THE PAYNE DEVICES EXEMPLIFIED BY EXHIBITS B, C and 9 INFRINGE DESIGN PATENT NO. 176,986 IN SUIT" pages 36-41.

F. There Was a Need for the Design of the Patent in Suit Which Was Satisfied by the McPhee '986 Design—Finding 7.

In order to win new sales in the very competitive bar equipment market, it is necessary that a manufacturer make available to the department store, jobber and professional buyer, something new, different and salable to attract their interest [TR. 226, 258-259]. Mr. McPhee testified:

> "When we attend trade shows, . . . the first question that a buyer asks is 'What's New?' and if you don't have an answer for 'What's New?', the interview is practically terminated." [TR. 277].

In order to answer the question "What's New?" in the affirmative, it is essential that a manufacturer constantly be on the search for something "new" to fulfill this need [TR. 258-259]. Mr. McPhee, so that he might have a good answer, worked the "first half of 1954" on the development of the "skirt concept" [TR. 255] which ultimately resulted in the design of the patent in suit. It was, from this expressed need, that Mr. McPhee felt there was a good market and need for a dressed up automatic liquor pourer [TR. 227]. Starting from his old device with no skirt [TR. 256-257, DX. H], he set about to develop and did develop something new [DX. A and G] for the market [TR. 260]. Thus, at the time that the pourer with the skirt [DX. G] was available to the public, Mr. McPhee was able to say: "We have a brand-new liquor pourer." [TR. 278].

The fullfillment of the need for the new liquor pourer by the patentee is evidenced by the fact that when the new product with the skirt [DX. G] came on

the market, it actually depressed the price of the original automatic liquor pourer [DX. H and O] and it was able to capture and maintain the premium *gift market* [TR. 227-228, 275].

> "A. It is the . . . over-all concept, . . . with the addition of the skirt in the liquor pourer . . . (that) automatically separates it in the buyer's mind, because this is a different one with a skirt; and, therefore, . . . it can command more in the market, . . ." [TR. 260].
>
> "The long felt need remained unsatisfied in spite of the attempts of the prior art. The peculiar combination of old elements necessary to actually accomplish the desired function had eluded both the artisan and the skilled mechanic for years. The Schneider patent hit upon that very combination with the result that it performed while the others merely promised. This result is sufficiently 'new,' 'unusual' and 'surprising' to indicate inventiveness" *Twentier's Research, Inc. v. Hollister Incorporated*, (9 Cir. 1963) 319 F. 2d 898, 902; *Goodyear Tire & Rubber Co. v. Ray-O-Vac Co.*, (1944) 321 U.S. 275, 279, 64 S. Ct. 593, 595, 88 L. Ed. 721; *Paramount P. Corp. v. American Tri-Ergon Corp.*, (1935) 294 U.S. 464, 474, 55 S. Ct. 449, 79 L. Ed. 997, 1003; *Hayes v. Brown, supra*, 291 F. 2d 319, 322.

Originally, the price level for automatic liquor pourers without a skirt [DX. H and O] was approximately $2.98; however, when the new design [DX. G] hit the market, this price level was reduced one third (⅓) to $1.98. [TR. 228-230, DX. Q, R, S and T, TR. 239-246].

As we will next see, the automatic liquor pourer with the skirt [DX. G] made under the teachings of the patent in suit [DX. A] outsell the prior devices, without the skirt [DX. H and O] two to one.

G. Commercial Success—Findings 8, 9, 10 and 11.

Commercial success, though a make-weight in the determination of validity of a patent, "where the patentability question is close" *Pointer v. Six Wheel Corporation,* (9 Cir., 1949) 177 F. 2d 153, 156, is of importance when the patent is inventive over the prior art. *Hayes v. Brown, supra,* 291 F. 2d 319, 322; *Neff v. Cohn, supra,* 298 F. 2d 82, 87. *Indeed,* this Court has held in *Brown v. DeBell, supra,* 243 F. 2d 200, 202:

> "Commercial success is of great importance in determining the validity of a *design patent.* Glen Raven Knitting Mills, Inc., v. Sanson Hosiery Mills, Inc., 4 Cir., 189 F.2d 845. This is so because the objective of most such designs is to enhance saleable value. The realization of this objective shows that the design must have been sufficiently novel and superior to attract attention." (Emphasis added).

Appellees first made an automatic liquor pourer without a skirt to which was later add a decorative skirt [TR. 223-224, 256-257; DX. G, H and O]. When the new ornamental pourer designed by Mr. McPhee came on the market [DX. G], it met with immediate success. Mr. McPhee testified: ". . . The sale of Exhibit G, that is the pourer with the skirt, is in all cases 2 to 1 over the sale of Exhibit O (without the skirt)" [TR. 230].

The testimony of Mr. McPhee [Tr. 230-238] where he testified from his original business records [DX. P-1 through P-6, inclusive] on the sale of his commercial devices with and without the skirt [DX. G and H, respectively] fully demonstrates the commercial value of the design of the patent in suit and substantiates his statement that the sale of the patented devices, such as Exhibit G, are "2 to 1 over the sale of Exhibit O (without the skirt)." [TR. 230, DX. H and O].

See also the discussion under the heading "There Was a Need For the Design of The Patent In Suit Which Was 'Satisfied By the McPhee '986 Design' in Finding 7" pages 27-29 as further support of Findings 8 through 11, inclusive.

H. The Disclosure of the McPhee '986 Patent Amount to Invention—Conclusion of Law 5.

All Courts have found difficulty in defining precisely what is "invention." Judge Jertberg, speaking for this Court, has defined invention as: ". . . the 'something' which the combination of old elements in this patent contributes to the art, and renders the 'whole' more than 'the sum of its parts?' It works. None of the prior devices did." *Twentier's Research, Inc. v. Hollister Incorporated, supra,* 319 F. 2d 898, 902.

On the subject of whether or not the design of the patent in suit is new, original and ornamental, the testimony of Appellees' expert is of interest. Mr. Gilson, a design engineer of considerable repute [TR. 11-15, DX. D and E. Finding 26], testified as follows:

The devices made under the teachings of the patent in suit ". . . are round, shapely, attractive objects." [TR. 26].

> "So I would say that a device of this nature, for pouring liquor, should be elegant, it should have an attractiveness, a brightness, it is normally given as a gift, although many people possibly buy them, too, for their functional value, for their own use, but the fact that people buy them for gifts I think attests to the fact, too, that they are now an accepted item, . . ."
>
> * * *
>
> "So I think Mr. McPhee has created something new, novel, and very useful and it has increased the acceptance of this product. The appearance is what creates this. He has made the lower section more acceptable. . . . I would be proud if I had *designed it* . . ." [TR. 64-65].

When all of the factors thus far discussed are considered, the Trial Court's Findings of Fact 7, 8, 9, 10, 11, 14, 15, 16, 18, 19, 20 and 23, the Conclusions of Law 3, 4, 5, 7 and 8 are fully supported by the evidence which was before the Trial Court and are not "clearly erroneous" FRCP Rule 52(a).

To paraphrase this Court's quotation in *Twentier's Research, Inc. v. Hollister Incorporated, supra,* 319 F. 2d 898, 902, the McPhee design has that "something" which contributes to the Arts and renders to the "whole" a more pleasing appearance than the sum of its parts. It is a new, original and ornamental design, and as such, amounts to invention within the meaning of Title 35 U.S.C. §171.

I. The Design of the McPhee 176,986 Patent in Suit Was Not Dictated by Functional or Mechanical Requirements.

Appellants, in their brief, contended that the design of the patent in suit [DX. A] "was dictated by functional or mechanical requirements . . ." [O. B. 8], and point to the testimony of Appellees' expert, Channing Gilson, [O. B. 26] and his reference to the ". . . messy connection between a bottle top and a pourer." Mr. Gilson's entire statement reads as follows:

> "A. . . . So I think the public is looking for and expect to find in objects like this attractiveness, utility, of course, which perhaps is not my area to discuss, but even the skirt which was added for the one decorative purpose has a functional aspect, too, that it does cover up the messy connection between a bottle top and a pourer." [TR. 65].

Appellants also point to the cross-examination testimony of Mr. McPhee on this subject which is:

> "Q. Looking at the skirt on Exhibit G, doesn't that also perform a function in that it conceals the cork. A. Well, the bottle actually conceals the cork.
>
> Q. It conceals the neck of the bottle? A. Yes.
>
> Q. So when the jigger or pourer of Exhibit G is placed on the neck of a bottle it acts as a screen or shield to conceal the neck of the bottle? A. It adds a decorative shield to conceal the neck of the bottle, yes." [TR. 260-261].

It is submitted that covering up a connection between the cork and the bottle is as Mr. McPhee suggests, one of the very purposes for which the ornamental design

of the '986 patent was intended. This is supported by the testimony of Mr. Gilson, where he testified that the *skirt* ". . . hangs freely from and around the neck of the bottle." [TR. 32-33]. Mr. Grossman, Appellants' expert, agrees with this conclusion. He testified:

> "Q. And, Mr. Grossman, I will ask you, insofar as the attachment of the skirt —. . .
>
> *It has no function in and of itself?* A. *Other than to just cover something.*" [TR. 100].

From the above, it is evident that Mr. Gilson's reference to the word "functional" was not in the sense that it was mechanically functional in the operation of the Appellees' device. Each of the Appellees' commercial structures, with and without the skirt [DX. G and H, respectively], mechanically operate the same [TR. 227]. Even so, this Court held:

> "It is true that the purpose of Congress in authorizing the grant of design patents was to give encouragement to the decorative arts. Such patents contemplate not so much utility as appearance. Gorham Co. v. White, 14 Wall. 511, 81 U.S. 511, 20 L.Ed. 731. But it does not follow from this that a design which comprehends a useful, in addition to a decorative, purpose cannot be the subject of a valid design patent. While it is the design which is patented, it is immaterial that the subject of the design may embody a functional or utilitarian purpose. (citing Dietz Co. v. Burr & Starkweather Co., 2 Cir., 243 F. 592, 594; Falcon Industries, Inc., v. R. S. Herbert Co., Inc., D.C.E.D.N.Y., 128 F. Supp. 204.)"
>
> *Brown v. DeBell, supra,* 243 F. 2d 200, 202-203.

On this subject, the New York District Court had this to say:

> "Invalidity is further urged because of the functional elements of the plaintiff's design, and if this means that only a design which comprehends no useful elements can be the subject of a valid design patent, it does not correctly state the law. The statute is not restricted to solely aesthetic concepts.
>
> Judge Hough said in Dietz Co. v. Burr, etc., 2 Cir., 243 F. 592, at page 594:
>
> 'While design patents are not intended to protect a mechanical function, or to secure to the patentee monopoly if any given mechanism or manufacture as such, it is immaterial that the subject of the design may embody a mechanical function, provided that the design per se is pleasing, attractive, novel, useful and the result of invention. Ashley v. Weeks, etc., Co. [2 Cir.], 220 F. [899] at [page] 901, 136 C.C.A. 465. But it is the design that is patented, not the mechanism dressed in the design.'"
> See also, *In re LaMontagne*, Cust. & Pat. App., 55 F.2d 486, at page 488.
>
> *Falcon v. Herbert, supra*, 128 F. Supp. 204, 212.

J. There Is No Double Patenting by the Grant of the McPhee Utility Patent No. 2,667,290 and the McPhee Design Patent No. 167,986—Finding 23.

In *Falcon v. Herbert, supra*, 128 F. Supp. 204, at 212, the Court, quoting from *Bayley & Sons v. Standart, etc.*, (2 Cir., 1918) 249 Fed. 478, 479, said:

> "If the same man at the same time devises a container of pleasing design and a mechanical con-

trivance conveniently united with the aesthetic covering, he has made two inventions; and, though he patents one, that is no reason why within the statutory two years he may not patent the other. Such act would not be necessarily a case of double patenting, which is always unlawful. The question is unaffected by the accident that one of the two compared patents is for a design and the other for a mechanical arrangement of matter; and it is always the same, viz.: Is the same thing or inventive thought disclosed by both? Williams [Calk] Co. v. Neverslip, etc., Co., C.C., 136 F. 210; President [Suspender] Co. v. Macwilliam, D.C., 233 F. [433] 439."

Also it was said in In re Barber, Cust. & Pat. App., 81 F.2d 231, at page 232.

"It is also well established that while, as a matter of law, one may have a mechanical patent and a design patent upon the same subject-matter, there must be a clear patentable distinction between the two; or, in other words, they must involve different inventions."

A cursory comparison of the McPhee '290 patent [PX. 3-A] with the design of the patent in suit [DX. A] leaves little doubt that the two devices "involve different inventions."

Briefly, the McPhee '290 patent has, in the words of Appellants' expert, Mr. Grossman, "no skirt" [TR. 86], nor does it have a "pinched-in waistline." *Cf., Alladin Plastics, Inc. v. Jerrold Stephan Co., supra,* 362 F. 2d 532, 533.

III.

THE PAYNE DEVICES EXEMPLIFIED BY EXHIBITS B, C AND 9 INFRINGE DESIGN PATENT NO. 176,986 IN SUIT—FINDINGS 25, 26 and 27.

A. The Tests of Infringment.

"We are now prepared to inquire what is the true test of identity of design. Plainly, it must be sameness of appearance, and mere difference of lines in the drawing or sketch, a greater or smaller number of lines, or slight variances in configuration, if insufficient to change the effect upon the eye, will not destroy the substantial identity."

Gorham Mfg. Co. v. White, supra, 14 Wall. 511, 526-527, 20 L. Ed. 731, 737.

". . . *(T)he design as a whole, and not any part of it as a part, and it is to be tested as a whole* as to novelty and infringement." (Emphasis added).

Dobson v. Dornan, supra, 118 U.S. 10, 15, 6 S. Ct. 946, 948, 30 L. Ed. 63.

This Court has said the test to be applied with regard to the infringement of design patents out is

". . . as stated in Gorham Mfg. Co. v. White, 14 Wall. 511, 528, 81 U.S. 511, 528, 20 L. Ed. 731, is as follows:

'* * * if, in the eye of an ordinary observer, giving such attention as a purchaser usually gives, two designs are substantially the same, if the resemblance is such as to deceive such an observer, inducing him to purchase one supposing it to be

the other, the first one patented is infringed by the other.' "

Reachi v. Edmond, (9 Cir., 1960) 277 F. 2d 850, 852; *Sunbeam Lighting Company v. Pacific Associated Lighting, Inc.*, (9 Cir., 1964) 328 F. 2d 300, 301; *Sanson Hosiery Mills v. Warren Knitting Mills*, (3 Cir., 1953) 202 F. 2d 395, 396.

When comparing the Appellants' infringing devices [DX. B, C and PX. 9], the comparison should be made with the patent in suit [DX. A], keeping in mind the similarities rather than the differences of the objects. The United States Supreme Court used this test in a Trademark action, equally applicable to a design patent action, where the Court quoted from *Gorham v. White* (a design patent case), *supra*, 14 Wall. 511. The Supreme Court said:

> ". . . (A)s a general rule, . . . exact similitude is not required to constitute an infringement or to entitle the complaining party to protection. If the form, marks, contents, words, or the special arrangement of the same, or the general appearance of the alleged infringer's device, is such as would be likely to mislead one in the ordinary course of purchasing the goods, and induce him to suppose that he was purchasing the genuine article, then the similtude is such as entitles the injured party to equitable protection, . . ." *McLain v. Fleming*, (1878) 96 U.S. 245-258; 24 L. Ed. 828, 831).

Again, speaking in terms of Trademark infringement, but as applicable to design patent infringement, the Court of Appeals for the 7th Circuit had this to say:

> Infringement "'. . . is not determined by comparing the two in juxtaposition only. Since it is the effect upon prospective purchasers that is important, the conditions under which they act must be considered. Purchasers do not always see the goods in juxtaposition. They rely upon memory and vague impressions. * * *' In Lactona, Inc. v. Lever Bros. Co., 144 F.2d 891, at page 893, 32 C.C.P.A., Patents, 704, the court said: 'It is true that by side-by-side comparison one can easily distinguish between the marks in question. However, such comparison is not the test for determining confusing similarity . . .'"
>
> *Albert Dickinson Co. v. Mellos Peanut Co., supra,* 179 F. 2d 265, 270.

B. The McPhee Design Patent '986 Is Infringed.

Appellees' expert, an Industrial Designer of some repute [TR. 11-15, DX. D and E], in the preparation for his appearance at the Trial, gave consideration to comparison of devices not alone as a technician [TR. 15-18], but as a consumer looking at a product for the first or second time [TR. 19, 58] ". . . as a total shape versus parts" [TR. 26]. *Dobson v. Dornan, supra,* 118 U.S. 10, 15; *Gorham v. White, supra,* 14 Wall. 511, 526, 527.

The three criteria Mr. Gilson used in *comparing* the devices [DX. A, B, and PX. 9], which the Court below found [Findings 25, 26 and 27], to be infringements of the McPhee '986 design patent in suit [DX. A], and

the Appellees' device with the skirt made in accordance with the teachings of the patent in suit [DX G] were:

(1) ". . . from the viewpoint of identification, how one might see this (for) the first time in a store, and analyzed the shapes involved here. . . . basically the size, *over-all configuration* of both is in my mind rather similar."

(2) "The second thing . . . I looked at . . . was the silhouette. . . . I compared the silhouettes of these two products"; and

(3) Then looked for the ". . . distinguishing feature of the design . . . I feel . . . the fact that it (the patent in suit) has a pinched-in wasitline is very distinctive . . ." [TR. 19].

To assist the Court in making this comparison, using the three criteria referred to above, Mr. Gilson testified

"*I prepared a graphic presentation* [DX. F] of what I think every average individual would see and be able to use as a guide in identifying one versus the other." [TR. 20].

Exhibit F is reproduced in the appendix.[2]

From Mr. Gilson's testimony, with the aid of Exhibits, A, B, C, F, G, and 9 [DX. B, C, PX. 9 being Appellants accused devices, DX. A, the patent in suit DX. G Appellees' device made under the teachings of the patent in suit] we find that the Appellants devices when compared with the patent in suit [DX. A] "are identical" or bear ". . . a very close resemblance"

---

[2]In Exhibit F, Figure 1 is a silhouette designed to represent an average sideview; Figure 2 is looking at the device "toward the spout"; and Figure 3 is a "top view looking straight down on the device." [Tr. 21].

to each other [TR. 22-24, 38-46, 58-62, 65-68]. And, as such, each is an infringement of Appellees Design Patent in suit.

The Cort's Findings of Fact numbered 25, 26 and 27, and its corresponding Conclusion of Law 6, each having to do with the issue of infringement, are fully supported by the evidence and are not "clearly erroneous".

C. Infringement by Appellants of the McPhee '986 Patented Device in Suit Is Not Defeated by the Teachings of the Prior Art.

We have seen above, in this brief, pages 10-25, entitled "THE PRIOR ART", nothing in the prior art teaches the distinctive features of the design of the patent in suit, which are: the "pinched-in waistline," [TR. 19] and the skirt that "flows freely away from the (rounded or bulbous) body" [TR. 27, 30 and 37]. There is nothing in the prior art in which Appellants can take refuge for the source of its design. It is obvious from this record, see discussion above, that the Appellants have appropriated the salient features of the Appellees' design patent in suit, and as such, are, by the import into and sale in the United States of their devices exemplified by Exhibits B, C and 9, guilty of infringement of Appellees patent in suit.

The record herein referred to fully supports the Court's findings which state in effect that the prior art alone or in combination does not limit counterclaimant's claimed infringement by plaintiffs—Findings 15, 16, 18 and 19.

Conclusion.

The judgment of the Court below, holding the patent in suit valid and infringed, was plainly correct and should be affirmed by this Court.

Respectfully submitted,

KENDRICK, SUBKOW & STOLZY,
ASHLEY STEWART ORR,
Attorneys for Appellees.

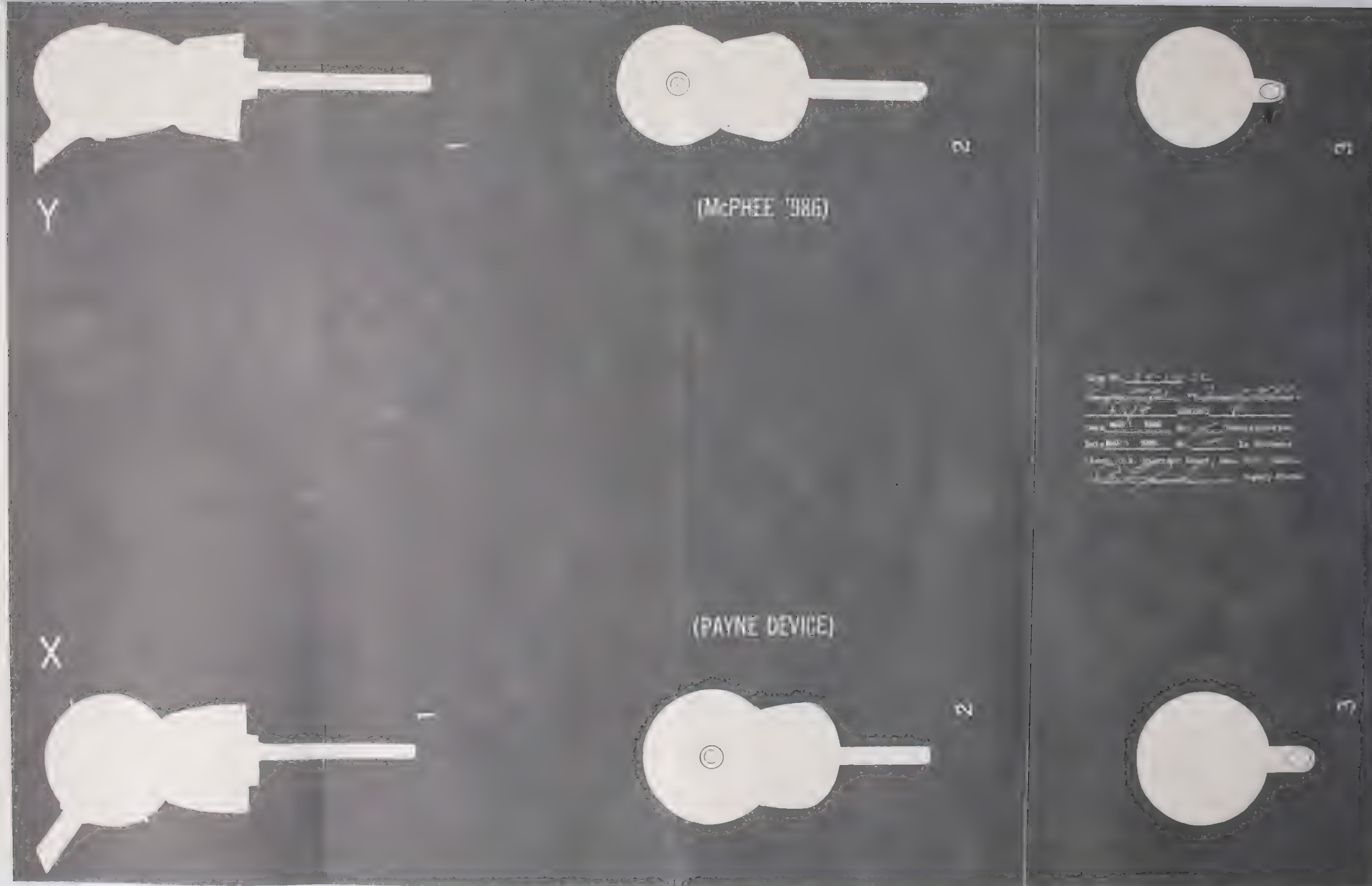
Dated: Feb. 10, 1967.

Certificate.

I certify that, in connection with the preparation of this brief. I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Ashley Stewart Orr

APPENDIX.



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NO. 21170

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

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LIMITED, a corporation, and
PAYNE MANUFACTURING COMPANY,
LIMITED, a corporation,

Appellants,

vs.

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Appellees.

APPELLANTS' REPLY BRIEF

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TOPICAL INDEX

TABLE OF AUTHORITIES

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APPELLANTS' REPLY BRIEF

Appellants Payne Metal Enterprises, Limited, and Payne Manufacturing Company, Limited, hereby submit this Reply Brief under Rule 18(4) of the Rules of the United States Court of Appeals for the Ninth Circuit.

I

THERE IS NO PRESUMPTION THAT A DESIGN PATENT IS NOT OBVIOUS

Appellees argue at length that the '986 design patent in issue here is presumed valid and that the presumption is strengthened by

the fact that the Patent Office considered the most pertinent prior art. Appellee's Brief, pp. 9-16, 21-25. But even if the Patent Office did consider the best prior art, the presumption of nonobviousness is not stengthened for the reason that, in effect, it never existed.

In the Report of the President's Commission on the Patent System (1966), the Commission, including Edward J. Brenner, Commissioner of Patents, recommended, in Part IV, that "all provisions in the patent statute for design patents shall be deleted, and another form of protection provided." Said the Commission (at page 12):

> "The Commission believes strongly that all inventions should meet the statutory provisions for novelty, utility and unobviousness and that . . . [design patents] cannot readily be examined for adherence to these criteria.
>
> "1. Designs: A patent now may be granted on any new, original and ornamental design for an article of manufacture. Despite the statutory requirement of unobviousness, patents on designs are now granted, in effect, solely on the basis of novelty. Courts often find these patents invalid on the ground that the design is obvious." (emphasis added).

II

THE McPHEE DESIGN DID NOT INVOLVE THE INVENTIVE FACULTY.

In Smith v. Whitman, 148 U. S. 678 (1893) the Court said:

"But as remarked by Mr. Justice Brown, then District Judge for the Eastern District of Michigan in Northrup v. Adams, 2 Bann. & Ard. 567, 12 Pat. Off. Gaz., 430, which was a bill for the infringement of a design patent for a cheese safe, the law applicable to'design patents does not materially differ from that in cases of mechanical patents, and"all the regulations and provisions which apply to the obtaining of protection of patents for inventions or discoveries . . . shall apply to patents for design." Sec. 4933.' And he added: 'To entitle a party to the benefit of the Act, in either case, there must be originality, and the exercise of the inventive faculty. In the one, there must be novelty and utility; in the other, originality and beauty. Mere mechanical skill is insufficient. There must be something akin to genius - an effort of the brain as well as the hand. The adaptation of old devices or forms to new purposes, however convenient, useful, or beautiful they may be in their new role, is not invention.' Many illustrations are referred to, as, for instance, the use of a model of the Centennial Building for paper weights and ink stands; the thrusting of a gas-pipe through the leg and arm of the statue

of a shepherd boy, for the purpose of a drop light; the painting upon a familiar vase of a copy of Stuart's portrait of Washington -- none of which were patentable because the elements of the combination were old."

* * * *

"The experienced judge by whom this case was decided conceded that the design of the patent in question did show prominent features of the Granger and Jenifer saddles, and united two halves of old trees, but he said: 'A mechanic may take the legs of one stove, and the cap of another, and the door of another, and make a new design which has no element of invention; but it does not follow that the result of the thought of a mechanic who has fused together two diverse shapes, which were made upon different principles, so that new lines and curves and a harmonious and novel whole are produced, which possesses a new grace and which has a utility resultant from the new shape, exhibits no invention.' And he held that this was effected by the patentee and that the shape that he produced was, therefore, patentable. But we cannot concur in this view.

"The evidence established that there were several hundred styles of saddles or saddletrees belonging to the prior art and that it was customary for saddlers to vary the shape and appearance of saddletrees in numerous ways according to the taste and fancy of the purchaser. ... Nothing more was done in this instance (except as hereafter noted) than to put the two halves of these saddles together in the

exercise of the ordinary skill of workmen of the trade, and in the way and manner ordinarily done."

Likewise, McPhee merely put together the old elements in Fig. 1 of McPhee U.S. Letters Patent No. 2,667,290 and the old skirt 12 of the Maloney patent. If a person skilled in the art wanted to protect the cork 13 in Fig. 1 of McPhee's U.S. Letters Patent No. 2,667,290 or cover up the messy connection between a bottle top and the pourer, he would obviously modify Fig. 1 by adding the Maloney skirt.

A design patent is invalid if it is a minor modification of a prior mechanical patent. Cf. Alladin Plastics v. Jerrold Stephan, 362 F.2d 532, 150 USPQ 10, 11 (9th Cir. 1966), where the Court said:

> "Design Patent No. D-192,029 discloses a chair seat which has precisely the same shape as that disclosed in mechanical Patent No. 3,034,830, the only difference being that it is constructed of flexible material. Patent D-192,029 may have been invalid under the rule recently applied in Bentley v. Sunset House Distrib. Corp., 359 F.2d 140, 149 USPQ 152, 156 (9th Cir. 1966), but we need not rest affirmance upon that ground. The minor modifications of size and curvature of prior art chairs reflected in the D-192,029 design are insufficient to satisfy the tests of 35 U.S.C.A. §171."

Of course, if a person skilled in the art wanted to use "a real fine application of the die-casting process", he would flare the skirt exactly as shown in the design patent in suit. So, the resulting "pinched-in-waistline" and skirt that "flows freely away from the body", which are repeatedly emphasized in Appellee's Brief, are nothing more than an "inadvertent by-product" and any pleasing aesthetic effect was "a minor windfall". See Bentley v. Sunset House Distributing, 359 F.2d 140, 149 USPQ 152, 156 (9th Cir. 1966).

Appellees devote only two pages of their brief, pp. 30-31, to the question of invention, which is now codified in 35 U.S.C. §103. Graham v. John Deere, 383 U.S. 1, 148 USPQ 459, 465-466 (1966).

> "While the ultimate question of patent validity is one of law, A. & P. Tea Co. v. Supermarket Corp., supra, at 155, 87 USPQ at 307, the § 103 condition, which is but one of three conditions, each of which must be satisfied, lends itself to several basic factual inquiries. Under § 103, the scope and content of the prior art are to be determined; differences between the prior art and the claims at issue are to be ascertained; and the level of ordinary skill in the pertinent art resolved. Against this background, the obviousness or nonobviousness of the subject matter is determined. Such secondary considerations as commercial success, long felt but unsolved needs, failure of others, etc., might be utilized to give light to the circumstances surrounding the origin of the subject matter sought to be

patented. As indicia of obviousness or nonobviousness, these inquiries may have relevancy. See Note, Subtests of 'Nonobviousness,' 112 U. Pa. L. Rev. 1169 (1964)." (emphasis added).

Appellees did not offer any objective evidence that the design "was less obvious than it appears". Griffith Rubber Mills v. Hoffar, 313 F.2d 1, 136 USPQ 334, 338 (9th Cir. 1963); Zero Mfg. Co. v. Mississippi Milk Assn., 358 F.2d 853, 149 USPQ 70, 75 (5th Cir. 1966). Instead, they offered the testimony of their expert that the devices of the patent were "round, shapely, attractive objects", of which he would have been "proud if . . . [he] had designed it . . ." Appellees' Brief, p. 31. Clearly, a "pleasing appearance" is insufficient in the absence of invention. Brown v. DeBell, 243 F.2d 200, 113 USPQ 172, 173 (9th Cir. 1957); Patriarca Mfg., Inc. v. Sosnick, 169 F. Supp. 204, 120 USPQ 143, 146, 148 (S.D. Calif. 1958), aff'd. 278 F.2d 389, 125 USPQ 260 (9th Cir. 1960). This is especially true where one element of the design "is perhaps a refinement over prior structures" and the other elements are contained in or suggested by the prior art. Margarian v. Detroit Products Company, 128 F.2d 544, 53 USPQ 658, 660 (9th Cir. 1942). Nor is it sufficient that the design is "new and pleasing enough to catch the trade". Hopkins v. Waco Products, 205 F.2d 221, 98 USPQ 51, 53 (7th Cir. 1953). As the Court said in Langsett v. Marmet, 231 F. Supp. 759, 141 USPQ 903, 908 (W.D. Wis. 1964), "scores of progressive ideas in business are not patentable". The words of Mr. Justice Murphy in Dow Chemical v. Halliburton,

324 U. S. 320, 64 USPQ 412 (1945) are especially apt. Said he (at page 415):

> " . . . He who is merely the first to utilize the existing fund of public knowledge for new and obvious purposes must be satisfied with whatever fame, personal satisfaction or commercial success he may be able to achieve. Patent monopolies, with all their significant economic and social consequences, are not reserved for those who contribute so insubstantially to that fund of public knowledge."

III

THE FINDINGS OF INFRINGEMENT ARE CLEARLY ERRONEOUS.

In Gorham v. White, 81 U. S. 511 (1871), the Supreme Court stated that the test of infringement was the "eye of the ordinary observer". Said the Court:

> "We hold, therefore, that if, in the eye of an ordinary observer, giving such attention as a purchaser usually gives, two designs are substantially the same, if the resemblance is such as to deceive such an observer, inducing him to purchase one supposing it to be the other, the first one patented is infringed by the other."

Accord: Reachi v. Edmond, 277 F. 2d 850, 125 USPQ 265, 266 (9th Cir. 1960).

Appellees failed to call a single "ordinary observer". Instead, they called an "expert witness" and the District Court apparently felt bound by this expert testimony. Finding 26 states:

> "26. Defendant's and counterclaimant's expert witness, Channing Gilson, an industrial designor, was the only qualified expert to testify. From Mr. Gilson's testimony we find that the accused liquor pouring devices created the same overall impression to the eye of the ordinary observer as the protected design of the McPhee patent in suit."

Appellees now argue that Mr. Gilson testified "not alone as a technician . . . , but as a consumer looking at a product for the first or second time [TR. 19, 58]". Appellees' Brief, p. 38.

Assuming that Mr. Gilson was able to put aside his experience as an industrial designer and testify as a "consumer", he nevertheless failed to use the "eye" of an ordinary observer. On the contrary, he used a "silhouette" test. In photographer's language, he compared the objects in backlight. And nowhere is there any evidence that "ordinary observers" view liquid pourers in backlight.

Mr. Gilson deliberately used an unreal test to eliminate depth perception and surface detail. Indeed, the word "silhouette" sounds suspiciously like industrial design terminology.

So, Mr. Gilson's testimony was worthless because (1) he was not an "ordinary observer", (2) he did not use the "eye" of an

ordinary observer" and (3) there was no proof of the pudding, i.e., that Mr. Gilson or anyone else was induced to purchase the Payne device supposing it to be the patented pourer. Even if Mr. Gilson's testimony is considered to be some evidence of infringement, that does not preclude a holding that the finding was clearly erroneous. As the Supreme Court said in United States v. Gypsum, 333 U.S. 364, 11 F.R. Serv. 52a., 42, Case 1 (1948):

> "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed."

See also 5 Moore's Federal Practice, Para. 52.03[1], p. 2616.

Since the only substantial evidence before the District Court was the patent drawings and the physical exhibits, Cf. Reachi v. Edmond, 277 F.2d 850, 125 USPQ 265, 267 (9th Cir. 1960), this Court should decide the issue of infringement by an independent analysis of the evidence. Burgess Vibrocrafters v. Atkins, 204 F.2d 311, 97 USPQ 366, 369 (7th Cir. 1953).

Appellants submit that the differences in the devices preclude a finding of infringement by this Court in the absence of any proof that an ordinary observer "purchased one supposing it to be the other".

Appellees' failure to find a single instance of confusion in the marketplace was the best possible evidence that there was and is no infringement. Cf. California Evidence Code §412.

Respectfully submitted,

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CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

/s/ Thomas P. Mahoney
THOMAS P. MAHONEY

No. 21172

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Alan Harvey Rice, Lawrence Stanford Toroker, Eddie Javor,

Appellants,

vs.

United States of America,

Appellee.

APPELLANTS' OPENING BRIEF.

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TOPICAL INDEX

Page

TABLE OF AUTHORITIES CITED

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APPELLANTS' OPENING BRIEF.

Preliminary Statement.

On June 16, 1965, a thirteen-count indictment was filed wherein the appellants herein, Javor, Rice and Toroker, and one Michael Anthony De Cristo were charged with violations of 21 U.S.C. 174 and 21 U.S.C. 176(a). All defendants were not charged in each count [Clk. Tr. pp. 2-14]. Eddie Javor was arraigned for these charges on July 6, 1965, and entered pleas of not guilty to counts 10 and 11 in the indictment. The matter was transferred to Judge Curtis for all future proceedings and continued to July 19, 1965, for trial setting [Clk. Tr. p. 16]. Rice and Toroker were thereafter arraigned and entered pleas of not guilty. On November 9, 1965, the trial of Javor, Rice and Toroker commenced before Judge Curtis with the selection of a jury and introduction of evidence by the Government. At this point counsel or Javor, Rice and Toroker were,

respectively, Samuel S. Brody, Erwin Sobel, and P. Basil Lambrose. Mr. De Cristo was not present and the Court forfeited his bail and ordered the issuance of a bench warrant. The Government moved to dismiss counts 6 and 7 of the indictment, which motion was granted by the Court [Clk. Tr. p. 19].

The trial continued from day to day until November 23, 1965, when the jury was instructed by the Court and sent out to deliberate. At 4:55 P.M. they returned with a finding that all three defendants were guilty of each charge with which they were named in the indictment. The case was continued until December 17, 1965, for hearing on motions for new trial and sentencing [Clk. Tr. p. 27]. The Court, on December 17, 1965, sentenced Javor to a term of seven years imprisonment on counts 10 and 11, to run concurrently [Clk. Tr. p. 28]. On January 3, 1966, Rice and Toroker were sentenced under the provisions of 18 U.S.C. 4208(b) for a 90-day study prior to sentencing [Clk. Tr. p. 78], and on May 16, 1966, after receiving reports on Rice and Toroker, their sentences were reduced to five years on each count, to be served concurrently [Clk. Tr. p 79].

Notices of appeal were duly filed on behalf of each of the appellants herein [Clk. Tr. pp. 57, 81 and 82].

Statement of the Facts.

The Government opened its case in chief with suggested stipulations as to the testimony of Herman J. Mueran, a government chemist, and the chain of custody involving certain exhibits [Rep. Tr. p. 76]. Although Government Exhibits 1A, 1B, 1C, 2A, 2B, 2C, 3A, 3B, 3C, 4A, 4B, 4C, 5A, 5B, 5C, 6A, 6B, 7A, 7B,

7C, 8A, 8B, 8C, 9A, 9B, 10A, and 10B were marked for identification, and the attorney for the Government described a proposed stipulation as to narcotic content and chain of custody [Rep. Tr. pp. 77-79], such a stipulation between Government counsel and defense counsel was never effected, and the witness, Mr. Mueron, was not questioned.

Ricard Salmi, a United States Federal Agent employed by the Federal Bureau of Narcotics for the past four and one-half years [Rep. Tr. p. 83], testified that on May 18, 1965, he met a person named Larry Sterling in Hollywood, California. Later that same evening he and Mr. Sterling drove up to Dominion Road in a Government vehicle [Rep. Tr. p. 83] to 8091 Dominion Way. Mr. Sterling knocked at the door and it was opened by the defendant Toroker [Rep. Tr. p. 84]. Agent Salmi told Toroker that he wanted to purchase an ounce of heroin that evening. Toroker replied that he was expecting an ounce of heroin to be delivered at the residence later that evening and asked Sterling and Salmi to stay in the house and await its delivery [Rep. Tr. p. 85]. Salmi and Sterling had a further conversation with Toroker while seated on the living room couch, where price and quality of the heroin was discussed [Rep. Tr. p. 86]. After a delay of one hour, Salmi told Toroker that he had to leave and got a phone number from Toroker in order to make future contacts, whereupon Salmi and Sterling left the premises. His next contact with Toroker was on May 19, 1965, at 11:00 A.M., when he called Toroker from the Federal Bureau of Narcotics [Rep. Tr. p. 88], and asked him when the ounce of heroin would be available. Toroker responded that he was expecting delivery at his resi-

dence between 7:00 and 9:00 P.M. that evening. Salmi stated that he would be there at 7:00 P.M. Salmi, by himself, again went to the residence on Dominion Way, knocked at the door [Rep. Tr. p. 89], and was admitted by Toroker who introduced him to a person named Mickey. Salmi asked Toroker in Mickey's presence if he had the ounce of heroin and Toroker stated that he did not but was expecting it to be delivered at any time [Rep. Tr. p. 90].

After placing a phone call, Toroker informed Salmi that he was unable to determine when the heroin would be delivered and asked Salmi in De Cristo's presence if he would be interested in purchasing an ounce of cocaine. Salmi responded that he was primarily interested in the quality of the heroin but would possibly purchase cocaine at a later date [Rep. Tr. p. 91]. Toroker informed Salmi that he had access to ample quantities of cocacine and had sold ten ounces of cocaine several days prior thereto, to an unknown person [Rep. Tr. p. 92]. After approximately one hour Salmi informed Toroker that he was leaving for Las Vegas and would contact Toroker upon his return. Toroker asked Salmi for his phone number and Salmi gave him his residence phone number [Rep. Tr. p. 93].

Agent Salmi called Toroker from Las Vegas, Nevada, on May 21, 1965, and Toroker informed him that he had an ounce of heroin in his possession which he would sell for five hundred dollars. That conversation then terminated but Salmi called Toroker back an hour and a half later [Rep. Tr. p. 95] and arranged to pick up the heroin at Toroker's residence later that same evening [Rep. Tr. p. 96]. At 10:30 P.M. on May 21, 1965, Salmi drove to Toroker's residence, alone, where he was

admitted by Toroker and invited to go into the downstairs recreation room where Mr. De Cristo was present. Toroker said, "I will go outside and get it", whereupon he left the room for approximately thirty seconds and returned with a rubber condom [Ex. 1C], which he handed to Salmi [Rep. Tr. p. 97]. Agent Salmi, after some further discussion, examined the contents of the condom and gave Toroker five hundred dollars in official Government funds, in De Cristo's presence [Rep. Tr. p. 99]. Toroker told Salmi as he was leaving that he and De Cristo were going to New York for the purpose of selling heroin, and if Salmi wanted any additional heroin, he should speak to Alan Rice [Rep. Tr. p. 100].

Salmi's next contact with Toroker was May 23, 1965, when Toroker called him at his residence [Rep. Tr. p. 101] and asked Salmi if he was satisfied with the narcotics. Salmi replied that he was not, whereupon a further discussion ensued relative to possible future sales of cocaine and heroin [Rep. Tr. p. 102]. On May 24, 1965, at 6:45 P.M., Salmi called the residence on Dominion Way and the phone was answered by Alan Rice [Rep. Tr. p. 103], who told Salmi that he would take care of Salmi's business and that he had a package of coke and three of the other at the residence, which he asked Salmi to purchase. Salmi told Rice that he didn't have enough money for the whole deal but would obtain additional funds and call Rice the next evening.

On May 25, 1965, at approximately 9:00 P.M. [Rep. Tr. p. 105], Salmi and agent Charles Sherman drove to the residence on Dominion Way and were admitted by Mr. Rice, to whom Salmi introduced Sherman as his

associate and asked Rice if he had the package [Rep. Tr. p. 107]. Rice answered affirmatively and stated that it was downstairs, whereupon they all walked down to the lower level of the house, where they looked for the package in a closet. A few minutes later De Cristo arrived [Rep. Tr. p. 108] and located a package in the closet, which he handed to Salmi [Ex. 2C; Rep. Tr. p. 109]. A sales price of $450 per ounce was agreed upon, the narcotics were weighed and two ounces set aside, when De Cristo stated they could have the remaining balance of the heroin for $195.00, which was agreed to by Salmi [Rep. Tr. p. 111]. Salmi then gave Rice $1,090 in official Government funds and put the two rubber condoms in his pocket [Rep. Tr. p. 112]. Rice told Salmi and Sherman that he would soon be in a position to sell kilogram quantities of heroin and Salmi replied that he would be interested in purchasing such quantities [Rep. Tr. p. 113]. As Salmi and Sherman were leaving, Rice told them that he could supply cocain for less than $1,000 per ounce [Rep. Tr. p. 114] and that if Sherman could come by the house, he would furnish him with a cocaine sample [Rep. Tr. p. 115].

On June 2, 1965, at 1:00 P.M., Salmi returned a phone call which Toroker had made earlier in the day to Salmi's residence. Toroker told Salmi he had "talked to the man" and could, within 24 hours notice, if Salmi had sufficient funds, deliver a kilogram of heroin in Los Angeles [Rep. Tr. p. 116]. At 9:30 P.M. that same day Salmi and Sherman drove up to the Dominion Way residence [Rep. Tr. p. 122] and were directed to the downstairs area by Mr. Rice [Rep. Tr. p. 123], where Rice produced a slip of paper [Ex. 11], which set forth prices relative to the purchase of European white and Mexican brown heroin [Rep. Tr. p. 127].

Salmi, Sherman and Rice had a conversation relative to the purchase price of different qualities of heroin, when Toroker came into the room and gave Salmi and Sherman three brown hand-rolled cigarettes each [Rep. Tr. p. 130; Ex. 4C], shortly after which Salmi and Sherman left the premises [Rep. Tr. p. 133]. Prior to leaving the residence, however, Rice told Salmi that he would call Salmi at his residence the following day in order to advise him of any further details regarding the kilogram of heroin transaction [Rep. Tr. p. 141]. At approximately 9:30 A.M. on June 3, 1965, Salmi received a phone call from Rice, at his Manhattan Beach residence, who informed him that the kilogram of heroin would be delivered in Los Angeles from Mexico late that evening, or the next evening. At 1:00 P.M. that same day Salmi called Rice and told him that he would be unable to meet on that day as he had other business [Rep. Tr. p. 142] and Sherman was not in Los Angeles with funds at that time. Agent Salmi called Rice on June 4, 1965, at 1:00 P.M. and asked about the heroin delivery. They arranged to meet in the Continental Hotel at 2:30 that afternoon, at which time and place Rice told Salmi that the kilogram of heroin would have to be delivered in two stages within a short time of one another [Rep. Tr. p. 143]. Salmi called Rice several times that day (June 4, 1965) and was eventually told there was no information about when the heroin would be delivered and was told to call Toroker the next morning [Rep. Tr. pp. 144-145].

Early in the afternoon of June 5, 1965, Salmi called Rice at his residence and was told by Rice that the kilogram of heroin should be delivered in Los Angeles the following evening and that later in the day the

source of supply would deliver a heroin sample to Rice's residence. At 7:00 P.M. the same day Salmi again called Rice at his residence and was told that the source of supply would be at Rice's residence [Rep. Tr. p. 178] in ten or fifteen minutes with a heroin sample. Salmi told Rice that he would be at Rice's residence as soon as possible to obtain a sample.

Agent Salmi arrived at the Dominion Way residence at approximately 9:00 P.M. that evening and noticed a new bronze-colored Buick station wagon, NRE-901, parked by the front door [Rep. Tr. p. 179]. He was admitted by a young woman he believed to be Rice's wife and was told that Rice was downstairs with Larry (Toroker). Agent Salmi started to walk downstairs when he met Rice, at the head of the stairs. Rice asked Salmi to wait in the front room as he had some business to transact and Salmi waited in the front room for about ten minutes, where he had a conversation with Mrs. Rice [Rep. Tr. p. 180]. Agent Salmi then heard a car door slam and Rice appeared in the kitchen and motioned for Salmi to follow him downstairs. As Salmi was walking downstairs, he heard the sounds of a vehicle being driven away from the front of the residence. Salmi asked Rice if he had the sample and Rice stated that he did. At this time Toroker entered the room from an outside door and had in his possession [Rep. Tr. p. 181] two knotted rubber condoms [Exs. 5C and 6B]. Toroker stated that one condom contained Mexican brown heroin [Rep. Tr. p. 182]. Agent Salmi took a portion of the lighter powder and placed it inside of an empty condom he was carrying for that purpose and placed a portion of the darker powder in some paper slips which Rice provided [Rep.

Tr. p. 184]. After some further conversation relative to the purchase of heroin, Toroker told Salmi that he was expecting the kilogram of heroin to arrive the next evening and Salmi informed Rice that he would call him the next day. The next contact was two days later on June 7, 1965, at 9:30 A.M., when Salmi received a call at his residence from Rice [Rep. Tr. p. 186]. Rice informed Salmi that he had just received ten ounces of heroin and had it in his possession at the Dominion Way address, where the transaction was to take place. Salmi told Rice that he would contact Sherman and have him return to Los Angeles with the necessary funds and that he would call Rice later that afternoon [Rep. Tr. p. 187].

At 1:00 P.M. on June 7, 1965, Salmi called Rice and asked him if he still had the ten ounces of heroin and upon receiving an affirmative response told him that Sherman would be in the city within a matter of hours with the available funds and that when he arrived they would go to the Dominion Way address, examine, test, weigh, and purchase the heroin [Rep. Tr. p. 188]. Agents Sherman and Salmi arrived at the Dominion Way residence at 4:30 P.M. that same day and were admitted by Rice; Toroker was not present at this time [Rep. Tr. p. 189]. Salmi asked Rice if he had the heroin and Rice said he did and would get it. In less than a minute Rice returned with a small brown paper bag that he handed to Salmi, which Salmi opened and observed two large condoms which each contained four smaller condoms [Exs. 7C and 8C; Rep. Tr. p. 190]. It appeared that two of the condoms were missing, which Rice said Toroker could account for when he returned. When Toroker entered the premises a few min-

utes later he was asked about the two condoms, left the premises and returned shortly with two condoms [Rep. Tr. p. 191], which he said were the two which had been opened for the purpose of extracting a sample from them. Agent Sherman then went out to his car and came back with a scale to weigh the narcotics [Rep. Tr. p. 192]. It was at this time that Salmi determined to place Rice and Toroker under arrest; however, prior to the actual arrest the agents had a short conversation about the price of this partial delivery with Rice and Toroker [Rep. Tr. p. 193].

After the arrest of Rice and Toroker, they were asked by Agent Voll if there was any more narcotics around the area and Rice responded that there was some heroin and cocaine on the outside of the residence, to which he led the agents under some ice plants [Exs. 9B and 10B; Rep. Tr. p. 199].

The testimony of Agent Charles Sherman consumed a considerable amount of time [Rep. Tr. pp. 241-295, 299-400]; however, it was in the main corroborative of the above-summarized testimony of Richard Salmi and will not be set forth, except where it adds materially to the testimony of Agent Salmi.

Agent Sherman's attention was directed to a telephone call received at the Dominion Way residence at 7:00 P.M. that evening, at which point counsel for Javor asked to address the Court out of the presence of the jury [Rep. Tr. p. 262]. Counsel for Javor objected to the introduction of the phone call, which objection

was overruled [Rep. Tr. p. 264]. Counsel for Javor also raised the question of whether or not Rice's alleged consent to monitor the call was freely and voluntarily given [Rep. Tr. p. 265] and asked to take the witness on voir dire in the jury's absence on this point [Rep. Tr. pp. 269, 270]. The witness was preliminarily questioned by the United States Attorney, in the jury's presence [Rep. Tr. p. 70], and then taken on *voir dire* by defense counsel, also in the jury's presence [Rep. Tr. p. 273]. Eventually the defense objections were overruled and Agent Sherman related the conversation in which a male voice named Eddie (later identified by Sherman as Eddie Javor) had an incriminating conversation with Rice and said he would be at the house in an hour to pick up the money [Rep. Tr. p. 282]. Approximately 15 to 20 minutes later Eddie Javor was arrested in the driveway outside of the Dominion Way residence [Rep. Tr. p. 283]. After Javor's arrest he was searched and a motel receipt [Ex. B] was taken from his person [Rep. Tr. p. 287].

John Tony Cagle testified that on June 5, 1965, he and Eddie Javor went to Torrance and purchased an automobile [Rep. Tr. p. 147] from Mr. Harry Okamoto [Rep. Tr. p. 148]. The car was purchased in the name of John P. Dexter by Tony Cagle for $75.00, which Javor had given to him [Rep. Tr. p. 149]. He met Javor at 10:00 P.M. that same evening and Javor was in the company of a lady [Rep. Tr. p. 152]. Cagle drove the 1952 Buick he had just purchased to Tijuana

and Javor drove his 1965 Buick to Tijuana [Rep. Tr. p. 154]. After they arrived in Tijuana, Cagle parked his 1952 Buick behind the La Sierra Motel and checked in as John Dexter. Javor and the woman also checked into the hotel at about 4:00 or 5:30 the morning of June 6, 1965. Cagle went to sleep and saw Javor at 2:00 P.M. that afternoon when Javor gave him tickets to the bull fights [Rep. Tr. p. 156], which Cagle attended. Cagle again saw Javor alone later that night in Cagle's motel room when Javor showed him a bag containing two prophylactics. At that time Cagle didn't know it was cocaine and Javor asked, "What can we do with this?" Cagle took the bag and put it into his coat pocket. Later that evening he returned to Los Angeles with Javor, the girl that came with them, and two other persons, in Javor's 1965 Buick. Cagle carried the packages with him back to Los Angeles [Rep. Tr. p. 158]. Cagle returned the contraceptives to Javor in Los Angeles [Rep. Tr. p. 159].

As can be seen the foregoing statement of facts presents the government's case in its best light. This is the manner in which an appellate court must review the record on appeal and it is from this point of view that the appellants write their opening brief.

ARGUMENT.

The Defendants Were Denied Due Process of Law in That They Did Not Have a Proper Determination Outside of the Jury's Presence That Their Confessions Were Voluntary.

The "confessions" of Rice and Toroker first came before the Court below when Charles E. Voll was called as a witness for the United States. He was a Federal Narcotics Agent and a group leader in the Los Angeles Office [Rep. Tr. p. 443]. His attention was directed to June 7, 1965, at 9:00 P.M. by Government counsel, when Mr. Lambrose, counsel for Toroker, requested a conference at the bench where he asked for a hearing on whether certain confessions, which were going to be the subject of testimony by Mr. Voll, "were voluntary and not made under duress" [Rep. Tr. p. 444]. Counsel for Toroker urged that the defendants were under the influence of LSD when they confessed and that there was an unreasonable delay before they were arraigned [Rep. Tr. p. 445]. The Court expressed concern about the defense contention that the defendants were under the influence of LSD when they confessed; and even Government counsel conceded that this was going to be a question of fact [Rep. Tr. p. 446].

After further discussion between the Court and counsel, it was determined that the jury would be excused and the Court would take evidence in their absence. Agent Voll testified that at 9:45 on June 7, 1965, he spoke to Alan Rice in Room 414 of the United States Courthouse Building. Prior to his taking any statement, he ascertained from Rice that he was not under the influence of any drug or narcotic [Rep. Tr. p. 452]

and had Rice relate to him the events leading up to his arrest. Agent Voll again warned Rice of certain constitutional rights, but Rice said he wanted to make the statement, which he did [Rep. Tr. p. 453].

It is interesting to note that this Constitutional warning was given after Rice had completely confessed orally to Agent Voll, but prior to his written statement [See Rep. Tr. pp. 452-453], which would make any warning a nullity.

At 12:40 A.M. on June 8, 1965, Agent Voll spoke to Toroker in Room 414 of the Federal Building, where Toroker denied that he was addicted to narcotics [Rep. Tr. p. 454] and was not then under the influence of narcotics. Agent Voll then advised Toroker of his constitutional rights, whereupon Toroker waived the services of an attorney and made a statement [Rep. Tr. p. 455], which he reviewed, corrected and signed in Agent Voll's presence [Rep. Tr. p. 456]. Agent Voll further stated that Rice and Toroker appeared to be normal when they made, corrected and signed their respective statements [Rep. Tr. p. 460].

Mr. Lambrose, counsel for Toroker, first offered to submit the Court the medical reports of Dr. Von Hagen and Dr. Tweed on the issue of voluntariness, in addition to certain extracts from medical textbooks [Rep. Tr. p. 464]. Counsel for the Government suggested the appointment of an independent expert, Dr. Sidney Cohen, to determine sanity at the time of the offense.

The Court recognized at this point that the crux of the matter was going to be the credibility afforded Rice and Toroker's testimony on the extent of their use of LSD, whereupon counsel for Toroker stated that he

had witnesses who would establish this use as a matter of fact [Rep. Tr. p. 465].

It was at this point that the Court clearly evidenced what it believed its role to be at Reporter's Transcript pages 468-469, by stating:

> "I have not read the doctors' reports but it occurs to me in view of the testimony that it is going to become a factual question the extent to which the defendants have been using and were using LSD at the time. If they were not using it and were not under the influence then there will be no question but what this is admissible or that it is valid.
>
> "If the jury believes the evidence, which will be conflicting, that the defendants were under the influences from whatever the evidence then the admission or the confession will be deemed not voluntary and will be disregarded. Our question at this point is, is this a Court question or a jury question. I am of the opinion, without having read all this, that it is a jury question and not a Court question.
>
> "There is evidence that the jury may well find that the defendants were normal and acting normal and were not acting under the influence of any drugs or any stimulants.
>
> "The defendants will dispute it. Perhaps the jury ultimately will decide that the defendants are right.
>
> "We are talking about the admissibility at this point. It seems to me we have a fairly simple question and that is the evidence as it has been adduced so far I think is such that the confessions

> must be admitted with the proper instruction to the jury at the appropriate time as to what the effect of it is and how they are to handle it."

A reading of the above comment reveals that the Court below was clearly of the opinion that all factual controversies on the issue of voluntariness would have to be submitted to the jury with appropriate instructions. This, as will be shown *infra,* was a misunderstanding of the then applicable law.

The above proceedings took place on Friday, November 12, 1965. It was at this point that the case was recessed until Tuesday, November 16, 1965, at 9:30 A.M., when the Court again indicated that "this is a conflict in the evidence which I think must go to the jury" [Rep. Tr. p. 477], and

> "This has become a question which I feel the jury must ultimately decide, and I am admitting them with the thought that there is evidence which must go to the jury. It is up to them to make the decision ultimately in accordance with the instructions which I will later give them as to whether or not these confessions are intelligently and knowingly made." [Rep. Tr. p. 479].

After Agent Voll had been examined by Government counsel and cross-examined by defense counsel in the jury's presence, the Court submitted the issue of voluntariness to the jury, wherein it stated:

> "By overruling the objections which I just overruled, I have made no ultimate decision. All I have decided is that there is sufficient evidence both ways to justify it being brought before the jury for determination. So you must withhold

> any judgment upon the effect of this admission until you have heard all of the evidence. Then you may consider it only if you find that it has been made voluntarily and knowingly and with a full understanding of the import of the confession or admission." [Rep. Tr. p. 555].

Approximately one year and a half prior to the trial of this case, the United States Supreme Court published its opinion in *Jackson v. Denno,* 378 U.S. 368 (1964), wherein the procedure for handling the issue of voluntariness of confessions was dealt with at some length. That case and the one at bar have one very important and striking similarity. In both cases the Court was under the impression that if there was a factual issue on voluntariness, the Court must leave any final determination on the subject to the jury (378 U.S. at 377). This very procedure was deemed a denial of due process of law which compelled reversal by the Court in *Jackson v. Denno, supra,* at 378 U.S. 376-7. In that case the Court held that the issue of voluntariness must be determined after a full and complete factual hearing on the matter "in which both the underlying factual issues and the voluntariness of his confession are actually and reliably determined" (378 U.S. 380) by a trier of fact other than the jury which determines guilt or innocence (See the Court's observations at 378 U.S. 391 and footnote 19 on said page).

As in *Jackson v. Denno, supra,* the failure to hold a proper evidentiary hearing and reliably determine certain factual issues out of the jury's presence are prejudicial errors and require a reversal.

The Court Below Committed Prejudicial Error by the Manner in Which It Instructed the Jury on Entrapment.

Pursuant to request by the defendants Rice and Toroker, the Court at Reporter's Transcript pages 1441-1442 gave the following instruction on entrapment:

> "Two of the accused have offered a defense of unlawful entrapment as to each of the crimes charged against them in the indictment.
>
> "The law recognizes two kinds of entrapment. There is unlawful entrapment and lawful entrapment.
>
> "Where a person has no previous history or purpose to violate the law but is induced and persuaded by law enforcement officers to commit a crime, he is entitled to the defense of unlawful entrapment because the law as a matter of policy forbids a conviction in such a case.
>
> "On the other hand, where a person already has the readiness and the willingness to break the law, the mere fact that the Government agents provide what appears to be a favorable opportunity is no defense, but it is lawful entrapment.
>
> "When, for example, the Government has reasonable grounds for believing that a person engaged in illicit sale of narcotics, it is not unlawful entrapment for a Government agent to pretend to be someone else and to offer either directly or through an informer or other decoy to purchase narcotics from such suspected person.
>
> "If, then, the jury should find from the evidence before them that anything at all occurred respecting the alleged offenses involved in this case, the

accused was ready and willing to commit crimes such as those charged in the indictment whenever an opportunity was offered, and the Government merely offered the opportunity, the accused is not entitled to the defense of unlawful entrapment.

"If, on the other hand, the jury should find that the accused has no previous intent or purpose to commit any offense of the character here charged and did so only because he was induced or persuaded by some person of the Government, then the prosecution has seduced an innocent person and the defense of unlawful entrapment is a good defense and the jury should acquit the accused."

This is substantially the same instruction on entrapment as is found in Federal Jury Practice and Instructions, Mathes and Devitt, Section 10.12, which this Circuit and the First Circuit have found so erroneous as to require reversal therefor, *Notaro v. United States*, 363 F. 2d 169 (9th Cir. 1966); *Sagansky v. United States*, 358 F. 2d 195 (1st Cir. 1966); *Kadis v. United States*, 373 F. 2d 370 (1st Cir. 1967).

What is even more pertinent in this case is that the Court left out the most crucial portion of the entire instruction when it stated:

"If, then, the jury should find from the evidence before them that anything at all occurred respecting the alleged offenses in this case, the accused was ready and willing to commit crimes such as those charged in the indictment whenever an opportunity was offered and the Government merely offered the opportunity the accused is not entitled to the defense of unlawful entrapment."

Whereas the Mathes and Devitt instruction is as follows:

> "If then the jury should find *beyond a reasonable doubt* from the evidence in the case that, *before* anything at all occurred respecting the alleged offenses in this case the accused was ready and willing to commit crimes such as charged in the indictment whenever opportunity was offered, and that the Government agents did no more than offer the opportunity the accused is not entitled to the defense of unlawful entrapment." (Emphasis supplied).

A comparison of the instruction that was undoubtedly intended to be given with that actually given by the Court reveals that the jury was not told they had to find a predisposition on the accuseds' part to commit *before* the instant events *beyond a reasonable doubt* before they could convict. In our situation the jury had no standard, whereas in *Notaro v. United States, supra,* they were at least instructed on reasonable doubt in connection with this charge and predisposition to crime before any events occurred with regard to the specific facts in the case.

It Was Prejudicial Error to Admit Over Objection Other and Unrelated Crimes of Eddie Javor.

After being cross-examined by Government counsel about his trip to Mexico with Mr. Cagle, the following questions were asked of Mr. Javor with these ensuing answers, at Reporter's Transcript page 1217:

> "Q. You mentioned that you have, in fact, been convicted of a felony. A. Yes, I have.

Q. And that felony concerns narcotics? A. It concerns marijuana.

Q. Well, narcotics? A. Marijuana.

Q. Marijuana.

In regard to your prior felony conviction for marijuana you are aware that when you leave the United States through the border, the port of entry at San Ysidro, you must register at the port of entry there?"

At this point counsel for Javor objected and a conference was held at the bench where the Court asked Government counsel for an offer of proof, whereupon Government counsel briefly explained that certain convicted felons were obliged to register with Customs when they left and returned to the country. Government counsel went on to say that Javor had, in fact, registered on prior occasions,

> "but he did not on this particular weekend register, which is a material fact going to his knowledge, part of this particular offense in that it would show that he did not want to call attention to himself because they were bringing the contraband in. So this is most material and relevant." [Rep. Tr. p. 1218].

The Court apparently accepted the above-quoted offer of proof and admitted the evidence of Javor's failure to register [Rep. Tr. p. 1221]. Government counsel then proceeded to show that Mr. Javor did not register when he entered and left the country on the weekend in question and that he was aware that he was required by law to so register [Rep. Tr. pp. 1222, 1223].

At no time during the cross-examination was it brought out by Government counsel that Javor had

registered at other times he crossed the Mexican border. This is highly material because the actual evidence did not conform to the Government's offer of proof as set forth above, which would mean that the jury was never given any information that Javor had registered in the past and might thereby infer that he failed to register on this particular occasion because of guilty knowledge. What we have left, then, is evidence of an unrelated crime being introduced into evidence against Mr. Javor, "and its admission over objection constitutes prejudicial and reversible error." *Dias-Rosendo v. United States,* 364 F. 2d 941, 944 (9th Cir. 1966); *De Vore v. United States,* 368 F. 2d 396 (9th Cir. 1966).

It Was Error to Admit Those Portions of the Statements of Javor's Co-Defendants Rice and Toroker Which Referred to Javor Under the Guise of Impeachment of Said Co-Defendants.

Prior to the testimony of Federal Narcotic Agent Charles E. Voll regarding the Rice and Toroker confessions there was a conference in chambers (which was discussed in the appellant's first point on appeal), where counsel for Javor requested that any reference to Javor be deleted from the Rice and Toroker confessions [Rep. Tr. p. 479]. The Court, after reading the subject confessions, concluded that the confessions were devastating insofar as Javor was concerned and did not think they should be admitted as to him [Rep. Tr. p. 481]. In order to avoid this very problem, it was agreed between the counsel for Rice and Toroker that they would stipulate that their clients admitted doing the offenses charged in the indictment to Agent Voll [Rep. Tr. p. 484], which stipulations were actually

entered into between the Government and Rice and Toroker in front of the jury [Rep. Tr. p. 514].

Mr. Toroker took the stand and testified in his own behalf on both direct and cross-examination at considerable length [Rep. Tr. pp. 626-736, 869-1014]. During his cross-examination, counsel for the Government asked that Exhibit 15, which had previously been marked for identification, be handed to the witness. (Ths exhibit was a signed confession of Mr. Toroker). At this point counsel for Javor objected to the use of that particular exhibit because of its highly prejudicial effect as to Javor [Rep. Tr. p. 903], and further stated that the real purpose beyond the proposed introduction of these "impeaching" statements was to place before the jury evidence which was inadmissible against Javor [Rep. Tr. p. 904].

A fair reading of the record does, unfortunately, support counsel's statements in regard to the Government's reasons for introducing certain portions of Toroker's confessions. It is hornbook law that the statements of Toroker made after his arrest are not admissible against a co-defendant and the only relevancy of such statements is that they may be admissions, confessions, or impeachment of his testimony in court. At this point in the trial, the only relevant consideration was impeachment because it had previously been stipulated that both Rice and Toroker admitted the offenses charged in the indictment in their confessions. The one purpose of the statements to be offered could therefore be only for the impeachment of Toroker. In this regard counsel for Toroker was willing to stipulate that Toroker had been impeached in his previous confession and had further stated in his confession that per-

sons other than those he had named in court were involved in the subject crimes [Rep. Tr. pp. 912, 913]. Counsel for Toroker further offered to stipulate to any specific impeachment the Government desired, so long as Mr. Javor's name could be eliminated therefrom [Rep. Tr. pp. 913, 914, 920]. Counsel for Javor also requested that Javor's name be deleted from any statements of Toroker [Rep. Tr. pp. 928, 929].

When the proposed stipulations of Toroker's counsel are taken in conjunction with the stipulation that had been already entered into, it is regretfully apparent that the only intention of the Government in introducing the statements of Toroker was to illegally and unlawfully have them considered as to Javor only. This assertion is re-enforced by a reading of the allegedly "impeaching" statements of Toroker [Rep. Tr. pp. 948-974], where it is quite apparent that the only purpose served is to incriminate Eddie Javor.

In reaching its decision to admit the confessions of Rice and Toroker, wherein the name of Eddie Javor was mentioned as a supplier of narcotics, in a thoroughly prejudicial manner as originally determined, the Court below was undoubtedly relying on *Paoli v. United States,* 352 U.S. 232 (1957). The Supreme Court in a five to four decision held that it was not error to refuse to delete the petitioner's name from the confession of a co-defendant in a joint trial made after the termination of a conspiracy (which was never alleged or proven by competent evidence in our case) where the Court properly admonished and instructed the jury that the confession was to be used only to determine the guilt (or credibility as in our case) of the confessing defendant.

These very issues are now before the United States Supreme Court in *Gilbert v. California,* 384 U.S. 985 (1966), which has already been briefed and argued and should be decided in the very near future. This instant case, however, varies very greatly from *Paoli v. United States, supra,* in some very important particulars which would not bring it under the rule of that case even if it were controlling law in this case:

1. The Court in *Paoli* listed several important factors which led them to believe that the jury followed the Court's instructions. Factor No. 4 listed by the Supreme Court merits special attention, as the Court stated, "In the main Whitley's confession merely corroborated what the Government already had established. In the light of the Government's uncontradicted testimony implicating petitioner in the conspiracy, the references to petitioner in the confession were largely cumulative." In this instant case that yardstick does not apply as the Government produced little other credible evidence which would implicate Javor. A similar situation to that found in this instant case was discussed by the Court in *United States v. Cianchetti*, 315 F. 2d 584, 590 (2d Cir. 1963), where the Court analyzed *Paoli v. United States, supra*, in determining whether an appellant has been so substntially prejudiced as to require reversal. The Court in that case noted that the evidence against one of appellants was not overly powerful, in addition to which it was denied by the appellant in the Court below. In our case the evidence against Javor, outside of these hearsay statements, was in-

substantial and Javor denied or explained all of the evidence against him. It is true that no limiting instructions were given in *United States v. Cianchetti, supra;* however, this is only one of the two criteria discussed in that case.

2. In *Paoli v. United States, supra,* any deletion of the petitioner's name from the co-defendant's confession was determined to be impractical (352 U.S. at 237), whereas in our case such deletions were not only practical but were suggested by defense counsel [Rep. Tr. pp. 928, 929]. *United States v. Jacangelo,* 281 F. 2d 574, 576 (3rd Cir. 1960); *Oliver v. United States,* 335 F. 2d 724, 731-732 (D.C. Cir. 1964).

3. The alleged purpose of introducing certain portions of the Rice and Toroker confessions was for the purpose of impeaching the testimony of Rice and Toroker. It will be recalled that counsel for Toroker agreed to stipulate that Toroker had been impeached by his previous confession and particularly that persons other than those named by him in court were listed in his confession as being involved in the narcotic transactions [Rep. Tr. pp. 912-913]. Counsel for Toroker even offered to stipulate to any specific impeachment the Government desired, so long as Javor's name could be eliminated therefrom [Rep. Tr. pp. 913, 914, 920]. The only purpose in this alleged impeachment, therefore, was to place incriminating evidence involv-

ing Javor before the jury. In this regard the Court's attention is respectfully directed to *United States v. Gordon,* 253 F. 2d 177, 183 (7th Cir. 1958), where the Court found reversible error in an analogous situation when the hearsay admissions of a co-defendant were admitted as impeachment.

It should be additionally noted that the "impeaching" statements of Rice and Toroker were never established properly as being free and voluntary. See *supra.*

The Judgment of the Court Below Must Be Reversed for the Reason That It Was Never Established That Certain Exhibits Were in Fact Narcotics.

As is noted in the opening paragraph of the statement of facts, *supra,* there was neither expert testimony nor a stipulation regarding the narcotic content of the exhibits which the Government contended were narcotics. The Government in final argument specifically relied on the inference which arises under 21 U.S.C. Section 174, when the defendant is shown to have possession of the narcotic drug in order to convict [Rep. Tr. p. 1262], and the Court gave the Government's requested instruction [Clk. Tr. p. 42] in this regard [Rep. Tr. p. 1436].

This has been recently held to be reversible error in the Ninth Circuit, *Cook v. United States,* 362 F. 2d 548 (9th Cir. 1966).

Evidence of Possession of Heroin as to Javor Was Insufficient and the Argument of Counsel and Instructions Given by the Court With Regard Thereto Were Unlawful and Illegal as a Matter of Law.

The appellant Javor is charged in counts ten and eleven of the indictment with receipt, concealment, transportation and sales of heroin in violation of 21 U.S.C. 174. In closing argument the Government urged that the inference provided by the possession of heroin should apply in this case [Rep. Tr. p. 1262] and the jury was so instructed by the Court [Rep. Tr. p. 1436].

There was no direct or sufficiently substantial evidence of Javor's possession of the heroin described in counts ten and eleven of the indictment to warrant the giving of that instruction to the jury. Despite the fact that Javor is named as a principal in the indictment and the Court instructed the jury on aiding and abetting [Rep. Tr. pp. 1414-1421], it is apparent that he was not shown to be in actual or constructive possession of the heroin in question and the giving of the above instruction was error, *Hernandez v. United States,* 300 F. 2d 114, 120 (9th Cir. 1962).

It has also been recently held in the Ninth Circuit that the aiding and abetting instruction and common scheme and plan instruction such as that given in this case in a similar factual situation constituted reversible error. *Hill v. United States*, No. 21126 (9th Cir. 1967).

The evidence against Javor is insufficient to sustain his conviction on appeal.

The Court Below Committed Prejudicial Error When It Instructed the Jury That a Witness Is Presumed to Speak the Truth.

The Court instructed the jury at Reporter's Transcript pages 1417-1418 as follows:

> "An inference is a deduction or a conclusion which reason and common sense leads the jury to draw from facts which have been proved.
>
> "A presumption is a conclusion which the law requires the jury to make from particular facts in the absence of convincing evidence to the contrary.
>
> "A presumption continues in effect until overcome or outweighed by evidence to the contrary, but unless so outweighed the jury are bound to find in accordance with the presumption.
>
> "Unless and until outweighed by evidence to the contrary, these are a few instances in which the law makes presumptions or requires you to make presumptions.
>
> "The law presumes that a person is innocent of a crime or wrong; *that a witness speaks the truth. . .*" (Emphasis Supplied).

The above-quoted instruction would appear to be that in Mathes & Devitt, Federal Jury Practice and Instructions p. 387, Section 71.04, with one very important exception. In the book it does not state that "the law presumes that a witness speaks the truth" as the jury was instructed in this case. Even the standard jury instruction in Mathes & Devitt, *supra*, p. 111, Section 9.01, says that: "Ordinarily, it is *assumed* that a witness will speak the truth" (Emphasis supplied). Again at Reporter's Transcript page 1423 the Court gave the credibility of witness's instruction but used "presumed" instead of "assumed".

If the jury followed the Court's instructions, they would be obliged to conclude that they must believe that the Government agents spoke the truth "in the absence of convincing evidence to the contrary." One presumption logically carries the same weight as another, and the appellant contends he was denied the presumption of innocence in this trial and, as such, was deprived of due process of law and a fair trial. See *United States v. Meisch,* 370 F. 2d 768, 773-4 (3rd Cir. 1966). The defendants in this case were deprived of being clothed in a presumption of innocence until there is sufficient evidence to the contrary but after the first government witness testified were presumed guilty.

The Court Below Erred in Not Allowing Javor's Counsel to Show That John Tony Cagle Had Been Released on His Own Recognizance After Testifying Against Javor.

Eddie Javor's counsel called Federal Bureau of Narcotics agent Paulus as his witness [Rep. Tr. p. 1145] and sought to show that immediately after his testimony in this case, Cagle was released from jail on his own recognizance [Rep. Tr. p. 1148]; and counsel was thereafter precluded from going into that area.

Mr. Cagle's testimony, which was summarized, *supra,* was the strongest evidence against Javor in the trial because without it a conviction would have been impossible. When Javor was denied the right to show that this admitted perjurer had a motive for falsely testifying, he was denied a fair trial and due process of law.

Rice and Toroker Were Not Allowed to Prove Their LSD Consumption, Thus Destroying Their Defense of Insanity in the Eyes of the Jury.

One of the two defenses asserted by Rice and Toroker was insanity; and one of the crucial issues in that defense was the amount of LSD consumed by Rice and Toroker during the period in question. Stephen Bryan Cole, a defense witness, testified that he saw the defendants Rice and Toroker take substantial quantities of LSD during the period in question [Rep. Tr. pp. 553, 557], and that whenever he saw them—which was three or four times a week—they were always under the influence of LSD [Rep. Tr. p. 558].

The very next defense witness was Linda Marie Quante.—As soon as she took the stand, the Court indicated that it would not admit any testimony that was merely cumulative of that given by Mr. Cole, the preceding witness [Rep. Tr. pp. 577-578]. The very same thing occurred when the next witness, Regina Champlain, testified; only this time the Court actually sustained an objection on the ground that her testimony would be cumulative [Rep. Tr. pp. 595-596].

The crux of this problem was fairly summarized by counsel for the Government in closing argument, when she stated:

> "The next point is why the Government didn't bring in examining psychiatrists to examine the defendants in this regard. Now, you have two psychiatrists who testified in this case. We start with one basic principle, which is not refuted, and that is the one psychiatrist who did in fact examine the defendants Rice and Toroker, who said that at the time of their examination in September these men were sane, legally sane. They are sane today.

> "The only thing the man said was that they were insane at the time of the offense.
>
> "Now, you heard the testimony of both of these psychiatrists. Just what is going to prove whether or not these men were insane at the time of the offense? The psychiatrists can stand here all day long and say, 'Yes, it is possible LSD can make you insane.'
>
> "But they come down to one thing, and that is this: You don't know unless you have seen this individual affected by LSD. You don't know unless this individual—these defendants are telling you the truth in saying that all these times they were under the influence.
>
> "So it doesn't matter how many psychiatrists take the stand, except to aid us in understanding more about LSD. What does matter is if you are going to believe these men, then that is the test right there."

That argument was perfectly correct, because Dr. Tweed assumed the defendants were telling him the truth about their LSD consumption and used this as a basis of his finding that they were insane at the times of the instant crimes. So it was very much in issue how much LSD the defendants used and how often they were using it.

It is the appellant's contention that they were deproved of a fair trial and due process of law when the Court would not allow them to establish the frequency and quantity of their LSD usage. This error becomes all the more prejudicial when the Government argues that very point to the jury, having first precluded the

defendants from establishing the fact of their usage of LSD.

This situation is similar to the defense of alibi, when the defendant has multiple witnesses. Surely at some point such evidence does become cumulative, but not after one witness, as in this case.

The Jury in the Court Below Was Not Properly Instructed on the Issue of Insanity.

The appellants herein are aware that the instruction on insanity given by the court below [Rep. Tr. pp. 1441-1442] reflect the current status of the law in this Circuit, *Sauer v. United States*, 241 F. 2d 640 (9th Cir. 1957) and *Maxwell v. United States*, 368 F. 2d 735 (1966). This honorable Court did, however, state in *Maxwell v. United States*, *supra*, at 743 that it might again, in a proper case review the entire problem which would mean consideration of the A.L.I. formulation of the insanity instruction. See *United States v. Freeman,* 357 Fed. 606 (2d Cir. 1966).

It is respectfully submitted that the evidence of insanity in this case is sufficient for such consideration by this court and that the present instruction on insanity which was given in this case deny the appellants due process of law and a fair trial.

Conclusion.

It is respectfully submitted that based upon the record in this case the judgment of the court below should be reversed.

Richard G. Sherman,
Sherman & Sturman,
Attorneys for Appellants.

Certificate.

I certify that in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

R. G. Sherman

NO. 21172

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FOR THE NINTH CIRCUIT

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Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

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CENTRAL DIVISION

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TOPICAL INDEX

Page

TABLE OF AUTHORITIES

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APPELLEE'S BRIEF

I

STATEMENT OF PLEADINGS AND FACTS DISCLOSING BASIS OF JURISDICTION

On June 16, 1965 the Federal Grand Jury for the Southern District of California, Central Division, returned a Thirteen Count Indictment alleging violations of Title 21, United States Code, Section 174 and Title 21, United States Code, Section 176(a). The offenses described in the Indictment concerned heroin, cocaine and marihuana. Appellant Alan Harvey Rice was charged in all Counts of the Indictment. Appellant Lawrence Sanford Toroker was charged in nine counts of the Indictment, that is all counts except

Counts Three, Four, Six and Seven. Appellant Eddie Javor was charged in Counts Ten and Eleven of the Indictment. The defendant Michael Anthony DeCristo was charged in the first Four Counts of the Indictment [C. T. 2-14]. 1/

After arraignment and plea of not guilty to all counts, a jury trial was commenced on November 9, 1965, the Honorable Jesse W. Curtis, United States District Court Judge, presiding. The defendant, Michael Anthony DeCristo, having failed to appear, his bond was ordered forfeited and a Bench Warrant issued [C. T. 19]. On November 9, 1965 the Government moved to dismiss Counts Six and Seven of the Indictment which pertained solely to Appellant Alan Rice and the court so ordered [C. T. 19].

On November 23, 1965 the jury returned a verdict finding each Appellant guilty as to all counts for which they charged [C. T. 27].

On December 17, 1965 Appellant Eddie Javor was judged guilty as charged and sentenced by the Honorable Jesse W. Curtis to 7 years imprisonment on each of Counts Ten and Eleven to commence and run concurrently [C. T. 56]. On December 21, 1965 Appellant Eddie Javor filed a timely Notice of Appeal in the United States District Court for the Southern District of California appealing the judgment of conviction [C. T. 57].

On January 3, 1966 Appellant Alan Harvey Rice was adjudged guilty as charged and sentenced by the Honorable Jesse W. Curtis

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1/ C. T. refers to Clerk's Transcript.

to the maximum period provided by law and for a study as described in Title 18, United States Code, Section 4208(c). On May 16, 1966 the court having received and considered the report of such study, Appellant's sentence was reduced to 5 years on each of Counts One, Two, Three, Four, Five, Eight, Nine, Ten, Eleven, Twelve and Thirteen of the Indictment to commence and run concurrently [C. T. 76, 80].

On May 20, 1966 Appellant Alan Harvey Rice filed a timely Notice of Appeal in the United States District Court of the Southern District of California, appealing the judgment of conviction [C. T. 81].

On January 3, 1966 Appellant Lawrence Sanford Toroker was adjudged guilty as charged and sentenced by the Honorable Jesse W. Curtis to the maximum period as provided by law and for a study as described in Title 18, United States Code, Section 4208(c). On May 16, 1966 the Court having received and considered the report of such study, the Appellant was sentenced for a period of 5 years on each of Counts One, Two, Five, Eight, Nine, Ten, Eleven, Twelve and Thirteen to commence and run concurrently [C. T. 77, 79].

On May 20, 1966 Appellant Lawrence Sanford Toroker filed a timely Notice of Appeal in the United States District Court, Southern District of California, appealing the judgment of conviction [C. T. 82].

The defendant Michael Anthony DeCristo having been subsequently apprehended entered a plea of guilty to Counts Two

and Four of the Indictment and on January 3, 1966 was sentenced to a period of 5 years on each count to begin and run concurrently. On motion of the United States Attorney, the court ordered Counts One and Three dismissed [C. T. 78]. The defendant Michael Anthony DeCristo is not appealing his judgment of conviction.

II

STATUTES INVOLVED

Count Eight of the Indictment was brought under Title 21, United States Code, Section 176(a) which provides in pertinent part as follows:

> "Whoever fraudulently or knowingly . . . receives, conceals . . . or in any manner facilitates the transportation, concealment or sale of such marihuana after being imported or brought into the United States, contrary to law . . . shall be imprisoned not less than 5 or more than 20 years and, in addition, they be fined not more than $20,000.
>
> "Whenever on trial for a violation of this section the defendant is shown to have or to have had possession of the narcotics drug, such possession shall be deemed sufficient evidence to authorize conviction unless the defendant explains the possession to the satisfaction of the jury. . . ."

Jurisdiction of the District Court was based on Title 18, United States Code, Section 3231 and Title 21, United States Code, Sections 174 and 176(a). Jurisdiction of this Court is based on Title 28, United States Code, Sections 1291 and 1294.

III

STATEMENT OF FACTS

On May 18, 1965 Federal Narcotics Agent Richard Salmi, acting in an undercover capacity, was introduced to Appellant Lawrence Toroker at the residence of Appellants Rice and Toroker. During their ensuing conversation, Agent Salmi inquired about the availability of an ounce of heroin. Appellant Toroker advised that he was expecting delivery of an ounce of heroin and requested the Agent to remain [R. T. 83, 85]. Appellant Toroker stated the price would be $500.00 for an ounce of good quality heroin [R. T. 86]. After a period of time, Agent Salmi departed and made arrangements to contact Toroker at a later date [R. T. 88].

Agent Salmi returned the following evening and Mr. Toroker introduced Michael DeCristo [R. T. 90]. After placing a phone call, Mr. Toroker advised that he had been unable to determine when the heroin would be delivered. During this meeting Mr. Toroker introduced the subject of cocaine, inquiring if Agent Salmi would be interested in purchasing cocaine. Mr. Toroker stated

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2/ R. T. refers to Reporter's Transcript.

that he had access to ample quantities of cocaine and had recently sold ten ounces of cocaine. He further stated that his sole support was derived from the sale of narcotics and LSD (lysergic acid diethylamide) [R. T. 91-93]. As Agent Salmi was leaving, Mr. Toroker asked for a telephone number where he could contact Agent Salmi.

After a telephone conversation with Mr. Toroker wherein he advised that he was in possession of the ounce of heroin which he would sell for $500.00, the Agent returned to the residence on May 21, 1965, and purchased one ounce of heroin from Mr. Toroker in the presence of Mr. DeCristo for the sum of $500.00 [R. T. 95, 97, 99] (Counts One and Two of the Indictment). During this meeting, Mr. Toroker advised that he and Mr. DeCristo would soon leave for New York to deliver 8 to 10 ounces of heroin, and the Agent should contact Appellant Alan Rice for further narcotics purchases [R. T. 100]. As Agent Salmi was leaving the residence, Appellant Rice met them and asked Agent Salmi if everything was alright [R. T. 100].

On May 23, 1965 Agent Salmi received two phone calls from Appellant Toroker relative to cocaine. He quoted a sales price of less than $1000.00 an ounce. Appellant Toroker also stated that if the Agent had any interest in purchasing up to 5 ounces of heroin, he should call Appellant Rice [R. T. 102-103].

On May 24, 1965 the Agent called the residence and spoke to Appellant Rice. Appellant Rice stated that he had a package for the Agent of "one coke and 3 of the other" and that he should come

over that evening to purchase. The Agent was unavailable that evening, but agreed to come at another time [R. T. 103-105].

On May 25, 1965 Agent Salmi accompanied by Federal Narcotics Agent Sherman, acting in an undercover capacity, went to the residence. Appellant Rice greeted them and took them into the downstairs den. Michael DeCristo joined them and the Agent purchased the 85.360 grams of heroin described in Counts Three and Four of the Indictment for a total sum of $1,090.00 [R. T. 112]. During the negotiations Appellant Rice stated that an ounce would be a true ounce, that is 28 grams, and the sales price would be $450.00 an ounce. Mr. DeCristo agreed to let the agents have an additional quantity of heroin for $195.00 in compensation for the poor quality of the heroin purchased on May 21. Mr. Rice advised that he would soon be in a position to sell heroin in kilogram quantities and also that he could supply cocaine for a price of much less than $1,000.00 an ounce. Mr. Rice offered to furnish a 2-gram sample of the cocaine which would be representative of the quality of cocaine available for sale [R. T. 110-115, 242-246].

On May 26, 1965 Agent Sherman returned to the residence for the purpose of receiving the cocaine sample. Appellants Toroker and Rice took the Agent into a bedroom. Appellant Rice took a small metal wrapped package from a drawer. Inside the drawer, the Agent also observed three condoms approximately one-third full of powder. Appellants advised that this was cocaine. Appellants advised they wanted $600.00 an ounce for cocaine, that the cocaine came from Mexico just as the heroin did. Agent

Sherman received his .350 gram sample of cocaine and departed [R. T. 249-252] (Count Five of the Indictment).

On June 2, 1965 Agents Sherman and Salmi returned to the residence where they met Appellants Toroker and Rice. In the downstairs den Appellant Rice produced Exhibit 11 which was a price list for heroin. The price list showed that European White Heroin could be purchased for $17,500.00 a kilogram; that a kilogram of European Heroin measured 18 spoons per ounce or 648 spoons per kilogram. The European White Heroin would be delivered through Mexico. A kilogram of Mexican Brown Heroin would consist of a 35 ounce weight of 12 spoons per ounce or 420 spoons per kilogram, at a sales price of $14,300.00 per kilogram. It was agreed that the Agents would purchase a kilogram of European White Heroin [R. T. 126-129]. The Agents returned to the upper portion of the house where Appellant Toroker was seated rolling marihuana cigarettes. Appellant Toroker joined them and in his palm were 15 to 20 cigarettes which he offered to the agents; each Agent took 3 marihuana cigarettes [R. T. 138-255] (Count Eight of the Indictment).

On June 4, 1965, Agent Salmi met Appellant Rice at the Continental Hotel. During this meeting, Appellant Rice advised that his "source of supply" would not deliver the entire kilogram of heroin in one transaction. Rather, the first delivery would be 10 ounces of heroin and the balance to be delivered subsequently [R. T. 143].

On June 5, 1965 in a telephone conversation, Appellant Rice

advised Agent Salmi that the kilogram of heroin would be delivered in Los Angeles shortly and that the "source of supply" would deliver a sample of the heroin that night. In an evening phone conversation on the same date, Appellant Rice stated the "source of supply" would be delivering the sample heroin within the hour [R. T. 178-179]. Agent Salmi then drove to the residence. When he arrived, Appellant Eddie Javor's automobile was parked in the car port [R. T. 179, 517-518]. Inside the residence Appellant Rice would not allow Agent Salmi to enter the downstairs den. Shortly Agent Salmi heard Appellant Javor's automobile drive away, and Appellant Rice then invited the Agent into the downstairs den. Appellant Toroker entered the den from outside the house, carrying 2 rubber condoms containing powder [R. T. 180-182]. Appellant Toroker explained that 1 condom contained an ounce of Mexican Brown Heroin and the other contained an ounce of European White Heroin. Agent Salmi was given a sample from each of the condoms (Count Nine of the Indictment). It was agreed that the two ounces could constitute part of the kilogram sale. The first installment of heroin was soon to arrive in Los Angeles [R. T. 185-186].

Between 10 P. M. and midnight on June 5, Appellant Javor and his girlfriend met John Anthony Cagle in Los Angeles [R. T. 150]. They drove from Los Angeles to La Sierra Motel in Tijuana. Eddie Javor did not register with Customs when he departed the country. Although he was aware of the requirements and had registered in the past [R. T. 1222-1223, 1228]. Mr. Cagle registered as John T. Dexter [R. T. 155-166]. The following evening in

Mr. Cagle's motel room, Appellant Javor gave him a brown paper bag containing 2 prophylactics. In each of the 2 prophylactics were 4 separate condoms containing narcotics [R. T. 157-158].

When they left Tijuana, Mr. Cagle carried the bag of narcotics on his person. They arrived in Los Angeles between 5 and 6 A. M. on June 7 [R. T. 158-159]. Mr. Cagle returned the brown paper bag of narcotics to Appellant Javor [R. T. 159]. At 9:30 A. M. on June 7, Appellant Rice telephoned Agent Salmi. Appellant Rice stated he had just received the narcotics [R. T. 187]. At approximately 4:30 P. M. on June 7, Agents Salmi and Sherman returned to the residence where Appellant Rice gave them a brown paper bag containing 2 rubber condoms. In each condom was 4 smaller condoms of heroin [R. T. 190-261]. Appellant Toroker brought in the 2 other condoms from which Agent Salmi had received samples on his prior visit [R. T. 192] (Counts Ten and Eleven of the Indictment). Utilizing a Marquis Reagent the Agents tested the heroin and received a positive result, indicating the presence of an opiate [R. T. 193]. While this was transpiring, Appellant Rice asked for $7500.00 for the 10 ounces. Rice stated he would give the purchase price to his "source" who would pick up the balance of the kilogram in Tijuana [R. T. 259]. The Agents then arrested Appellants Rice and Toroker [R. T. 190-196]. Outside the house, the Agents recovered the heroin which is the subject of Count Twelve and the cocaine which is the subject of Count Thirteen of the Indictment [R. T. 200].

Following his arrest, Appellant Rice indicated that he wished

to cooperate with the Government and advised the Agents that he was expecting a call from his "source of supply". He gave permission to the Agents to monitor this telephone call [R. T. 271-272]. Thereafter, a telephone call was received from Appellant Eddie Javor. Rice stated "is this Eddie"? Javor replied "yea, is everything alright?" Rice stated "it's okay, but the people want the rest of the heroin". Javor said "Do you have the money for the 10 ounces?" Rice stated "yes, I have the money". Javor then advised that he would be over in about an hour to pick up the money and discuss the balance of the stuff [R. T. 282-283].

At approximately 7 P. M. Appellant Javor drove into the residence; at which time he was arrested. From his wallet was removed Exhibit 13 which was the La Sierra Motel receipt for the June 5, 1965 weekend stay of Mr. and Mrs. Eddie Javor and John T. Dexter [R. T. 517-522].

IV

ARGUMENT

A. TRIAL COURT MADE A FULLY ADEQUATE DETERMINATION OF THE VOLUNTARINESS OF THE CONFESSION.

Appellants Rice and Toroker contend that they were deprived of a proper hearing to determine the voluntariness of their confessions prior to the submission thereof to the jury.

Jackson v. Denno, 378 U.S. 368 (1964) provides only that

the procedures utilized at the trial level must be " . . . fully adequate to insure a reliable and clearcut determination of the voluntariness of a confession, including the resolution of disputed facts upon which the voluntariness may depend." 378 U.S. 391.

In Sims v. Georgia, 385 U.S. 538,No. 251 (January 23, 1967) the court stated:

> " . . . a jury is not to hear of a confession unless and until the trial judge has determined that it was freely and voluntarily given. The rule allows the jury, if it so choose to give absolutely no weight to the confession in determining the guilt or innocence of a defendant, but it is not for the jury to make the primary determination of voluntariness. Although the judge need not make formal findings of fact or write an opinion, his conclusion that the confession is voluntary must appear from the record with unmistakable quality."

There are two stages to the admission of a confession. The first being that the Court must satisfy itself preliminarily that the confession was voluntary, and the second being the defendant's right to ask the jury to pass upon question of voluntariness under proper instructions. Both facets of admissibility were complied with in the instant case. Appellants Rice and Toroker contended that involuntariness was premised on the fact that each was under the influence of LSD at the time of giving the confessions [R. T. 445].

When the issue was raised, the trial judge correctly defined the procedure when he stated, "the Court has to be convinced first of all that it is a voluntary confession or that the jury may reasonably consider it as a voluntary confession. Then it becomes a question for the jury to determine whether it is actually voluntary . . . are you willing to submit the question of its admissibility to the court on the basis of a confession, what it states, and upon the reports and what they state?" To which counsel replied "I think that is fair" [R. T. 447-448]. Thus in the instant case it was not only agreed that a hearing would be held, but Appellants by their own requests, set the scope of the hearing which was fully complied with by the District Court Judge.

After excusing the jury, the Court stated, "the record will show we are proceeding now in the absence of the jury for the purposes of determining whether or not the confessions of Mr. Rice and Mr. Toroker are admissible as voluntary." [R. T. 450-451].

After the hearing and at the beginning of the next trial day, the court determined that the confessions were admissible as voluntary. There resulted a discussion as to the manner of presenting the issue of voluntariness to the jury, and a suggestion was presented that the transcript of the hearing testimony be read to the jury. The court declined the suggestion and stated " . . . It first indicates to them that we have had a hearing outside of the jury, and the court has made this decision. Then they wonder, well, now, let's see, we want to decide the same way the Courts

decide." [R. T. 484-485]. As a result, the testimony was presented to the jury by the witness, and the court then properly instructed the jury regarding their duty [R. T. 514-515].

It is clear that the court in fact had a proper hearing and his conclusion of voluntariness appears from the record with unmistakable clarity. It is true that in instructing the jury on admissibility, the court stated he had made no decision, but had determined there was sufficient evidence to justify it being brought before the jury for determination. However, this instruction would merely seem to have given greater protection to the defendant's rights, for as the court noted, if he had advised the jury of the nature of his decision, this would have had in all probability been an improper comment on the evidence by persuading them to the court's point of view.

B. NO ERROR WAS COMMITTED BY GIVING THE INSTRUCTION ON ENTRAPMENT.

The second specified error alleges in substance that the trial court incorrectly charged the jury on the defense of entrapment.

At the trial Appellant Javor denied the commission of all offenses charged against him; Appellant Toroker denied the commission of the offenses charged against him in Counts One, Two, Five, Twelve and Thirteen [R. T. 672, 880, 681, 882-883, 720-721]; and Appellant Rice denied the commission of the offenses

charged against him in Counts One, Two, Three, Four, Twelve and Thirteen [R. T. 1048, 1050-1051, 1060-1061]. Where a defendant denies the commission of the crime, he is not entitled to the defense of entrapment, nor is he entitled to an instruction on entrapment.

> Ortiz v. United States, 358 F. 2d 107 (9 Cir. 1966);
> Ortega v. United States, 348 F. 2d 874 (9 Cir. 1965).

This alleged error challenges Appellant Toroker's conviction on only four of the nine counts for which he was convicted, and Appellant Rice's conviction on only five of the eleven counts for which he was convicted. Thus this claimed error should not be considered on appeal since Appellants Rice and Toroker were sentenced to five years on each count to run concurrently, and there are numerous counts which are unaffected by this alleged error.

> Mathes v. United States, 334 F. 2d 653 (9 Cir. 1965);
> Noah v. United States, 304 F. 2d 317 (9 Cir. 1962), cert. denied 375 U. S. 855;
> Redfield v. United States, 328 F. 2d 532 (C. A. D. C. 1964), cert. denied 377 U. S. 972.

Citing Notaro v. United States, 363 F. 2d 169 (9 Cir. 1966), appellants contend that the Federal Jury Practice and Instructions, Mathes and Devitt, Section 10. 12, Instruction on Entrapment, is erroneous. However, contrary to the facts of Notaro, appellants in the instant case, specifically requested the entrapment instruction and expressed their satisfaction with "the suggested ones in Judge

Mathes' book" [R. T. 859-860]. Under the circumstances, the failure to give a Notaro type instruction was not error.

Robinson v. United States, ___ F. 2d ___ (No. 20, 752, May 18, 1967, 9 Cir.).

Lastly, appellants contend that even if the form instruction was proper, the contents of the instruction as given was improper. In this regard appellant's failure to object forecloses the right to review. Recognizing all too clearly the possibility of human error in either the trial court's delivery of instruction or even the reporter's recording of instructions, Rule 30 of the Federal Rules of Criminal Procedure provides in part:

> "No party may assign as error any portion of the charge or omission therefrom unless he objects thereto before the jury retires to consider its verdict. . . ."

In the instant case, appellants did not object to the instructions as given [R. T. 1449].

Phillips v. United States, 334 F. 2d 589 (9 Cir. 1964), cert. denied 379 U.S. 1002.

C. EVIDENCE DISCLOSING ANOTHER OFFENSE WHICH IS INTERMINGLED WITH THE CRIME CHARGED IS ADMISSIBLE.

A person convicted of a violation of certain marihuana laws is required to register with Customs upon departure and return into the United States. Failure to do so, is a violation of Title 18, U.S.C. Section 1407.

Appellant Javor alleges it was prejudicial error for the Government to elicit on cross-examination that Appellant Javor, who was both subject to and aware of this requirement, deliberately chose not to register when he went to Tijuana on the weekend of June 5, 1965 [R.T. 1222-1223, 1228]. Such evidence was admissible to prove his knowledge of transporting heroin on that occasion and his lack of innocent purpose for the trip to Tijuana.

Reed v. United States, 364 F.2d 630 (9 Cir. 1966).

Additionally, as the evidence clearly establishes, Appellant Javor was the "source of supply" who made this specific trip to Tijuana to illegally import the narcotics for which he was charged in Counts Ten and Eleven.

The general rule that evidence of a separate offense is inadmissible,

> ". . . does not apply where the evidence of the other offense directly tends to prove the crime charged in the Indictment, or when a complete account of the offense charged and the defendant's

connection therewith cannot be given, without disclosing the particulars of such other acts, or when it is so connected and intermingled with the crime charged as to form one entire transaction, and proof of one involves proof of the other."

> Johnston v. United States, 22 F. 2d 1, 5 (9 Cir. 1927), cert. denied 276 U.S. 637;
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> United States v. Levine, 372 F. 2d 70 (9 Cir. 1967);
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> Theobald v. United States, 371 F. 2d 769 (9 Cir. 1967);
>
> Stewart v. United States, 311 F. 2d 109 (9 Cir. 1962);
>
> United States v. Phillips, 375 F. 2d 75 (7 Cir. 1967).

D. CROSS-EXAMINATION USE OF CONFESSIONS TO CHALLENGE CREDIBILITY WAS PROPER.

Following their arrest on June 7, 1965, Appellants Rice and Toroker separately gave written signed confessions. As the trial judge noted, the confessions were competent evidence; however, he did not have to decide if relevancy was outweighed by any possible prejudice to Appellant Javor who was identified as the "source of supply" in both confessions, since the jury was advised that Appellants Rice and Toroker stipulated that they had admitted the offenses charged in the Indictment [R. T. 514, 904].

In addition to contradicting other facts described in their confessions, Appellants Rice and Toroker testified that their

association with Eddie Javor only concerned household repairs. Appellant Toroker testified that he had seen Mr. Javor once in May and once in June regarding some resurfacing and upholstery work [R. T. 869-872]. Mr. Rice testified that his meetings with Mr. Javor only concerned building a roof on the recreation room, upholstery work and other household repairs [R. T. 1075-1077, 1113-1115]. Mr. Toroker testified that Michael DeCristo's supplier, Nick, had furnished the narcotics described in Counts Ten and Eleven [R. T. 710]. Mr. Rice testified that Appellant Javor did not supply any heroin [R. T. 1124]. Mr. Rice testified that after his arrest on June 7, 1965, Mr. Javor telephoned and the conversation was "This is Eddie Javor . . . is it all right to come up?", to which Mr. Rice replied "Come on up." [R. T. 1119-1120].

This testimony does not concern collateral matters. It is the crux of Counts Ten and Eleven of the Indictment, wherein each appellant is charged with the concealment, transportation and sale on June 7, 1965 of 237.345 grams of heroin.

The written confessions were admissible in the Government's case-in-chief, with proper limiting instructions, even though they contained the name of an absent non-declarant defendant.

Delli Paoli v. United States, 352 U.S. 232 (1957);

Marroso v. United States, 331 F.2d 601 (5 Cir. 1964), cert. denied 379 U.S. 899;

United States v. Aviles, 274 F.2d 179 (2 Cir. 1960), cert. denied 362 U.S. 974, 982;

United States v. Bando, 244 F.2d 833 (2 Cir. 1957),

cert. denied 335 U.S. 844.

United States v. Gordon, 253 F.2d 177 (7 Cir. 1958), reversed on other grounds 344 U.S. 414, is inapplicable since the defendant's statement admitted therein related only the guilt of a non-declarant co-defendant, and in fact were exculpatory statements as to the declarant defendant.

The cross-examination use of these confessions is vitally important after the Appellants Rice and Toroker voluntarily took the stand to not only deny the charges against themselves, but to affirmatively defend Appellant Javor in the crimes of which he was charged. To prohibit the cross-examination use of these confessions is to place a premium on perjury.

Bailey v. United States, 328 F.2d 542 (D.C. Cir. 1964), cert. denied 377 U.S. 972.

Further, if Appellant Javor thought he might be prejudiced by a co-defendant's confession, which implicated him, he should have requested a severance of defendants pursuant to Rule 14 of the Federal Rules of Criminal Procedure. Failure to request a severance should be deemed a waiver of this alleged error.

It should be noted that during the cross-examination of Appellants Rice and Toroker, and again during instructions, the trial court admonished the jury on numerous occasions that any reference to Eddie Javor was not to be considered as evidence against Eddie Javor, but solely for the purpose of impeachment of Appellants Rice and Toroker [R. T. 946-947, 1421-1422].

Appellant Javor contends that the cross-examination of

Lawrence Toroker was error for an additional reason. Counsel for Appellant Toroker offered to stipulate that he had impeached himself [R. T. 912]. Whether or not the Government is bound to accept a counsel's stipulation to the effect that his client has committed perjury, in lieu of questioning the defendant's credibility by cross-examination, is an apparently undecided legal issue. However, it is clear that the Government should not be forced to accept a stipulation. To have accepted this unique stipulation would merely result in a different allegation of error for appellate review.

E. APPELLANTS STIPULATED TO NARCOTIC CONTENT.

Appellants contend that the judgment must be reversed for failure to prove the narcotic character of the substances involved.

During the testimony of the Government chemist, defense counsel interrupted in the interest of saving time and offered to stipulate to the narcotic content and chain of custody as to the exhibits relating to each count of the Indictment. The record then discloses:

> "MRS. DUNNE: If I may take the time to mark each one of them, I will then offer the matters concerning what the substance is, is that agreeable, counsel, as to each of the defendants?" [R. T. 77].

To which each appellant agreed. Thereafter the jury was orally advised as to the weight and narcotic content of each exhibit.

Government counsel then inquired: "Does this correctly constitute the stipulation as I have phrased it?" [R. T. 78-79]. Although the record does not disclose an explicit answer, it is clear from this coloquy that the stipulation was agreed to.

A stipulation is an agreement between counsel and it is essential that the parties or their counsel assent to the terms thereof. However, this requisite assent to a stipulation need not be made in a formal manner. It may be implied from the conduct of counsel. Acquiescence by silence may constitute an assent to stipulate.

McBain v. Santa Clara Savings, 51 Cal. Rptr. 78 (1966).

Appellants should not now be allowed to repudiate the obligation of their own agreement to the stipulation which they initiated merely because explicit words of consent are omitted from the transcript.

Contrary to the decision in Cook v. United States, 362 F. 2d 548 (9 Cir. 1966), wherein the Government made no attempt to prove the narcotic character of the drugs, in the instant case there was a stipulation, and also the agents specifically testified that the substances described in Counts One, Two, Ten and Eleven were subjected to a Marquis Reagent test, which is a field test utilized to determine the presence of an opiate and the substances did produce a positive reaction indicative of an opiate [R. T. 101, 192-193].

F. THE EVIDENCE PROVED THAT EDDIE JAVOR HAD POSSESSION OF THE HEROIN DESCRIBED IN COUNTS TEN AND ELEVEN.

Appellant Javor challenges the sufficiency of the evidence of his possession of the narcotics described in Counts Ten and Eleven of the Indictment. He contends that since there was no proof of possession, it was error to give an instruction on aiding and abetting.

The facts as previously stated establish that Eddie Javor was the supplier of the heroin. He had actual physical possession when he gave the narcotics to Mr. Cagle in Tijuana. He illegally imported the narcotics by transporting it from Tijuana to Los Angeles. The telephone conversation wherein Eddie Javor asked if the money had been received for the 10 ounces of heroin shows clearly that he had joint constructive possession of the heroin when it was sold to the Agents on June 7, 1965.

In David A. Hill v. United States, ____ F.2d ____, No. 21,126 (9 Cir., May 5, 1967), this Court held that it is improper to give an instruction in regard to aiding and abetting unless there is proof that the defendant knew the narcotics had been unlawfully imported or that the defendant had actual or constructive possession. In the instant case, there was proof of both factors, therefore, the instruction was proper.

G. THE JURY INSTRUCTIONS ON WITNESS CREDIBILITY WAS NOT ERROR.

Appellants contend that instructing the jury that a witness is "presumed to tell the truth 'rather than' assumed to tell the truth" is error since it required the jury to believe the Government Agents and to presume guilt after the testimony of the first Government witness.

This point is without merit. In addition to presenting defense witnesses, each appellant testified in his own defense. The net result being that appellants are in the same position as if the trial judge had used the word assume rather than presume.

H. THE TRIAL COURT PROPERLY RESTRICTED EXAMINATION.

It is urged that the Court erroneously curtailed questioning of a defense witness as to whether or not the Government witness Mr. Cagle had been released on his own recognizance after he had testified. Contrary to appellants' contention, the most critical evidence against Mr. Javor was not Mr. Cagle but rather Mr. Javor's own words when he asked during a telephone conversation about the sale of the 10 ounces of heroin.

Initially, it should be noted that there was an in depth questioning of the witness, Mr. Paullus concerning any promises made to Mr. Cagle and specifically any promises relative to his

release from custody. Mr. Paullus denied such promises. The defense asked if it were not a fact that Mr. Cagle was at liberty. Objections were sustained. A party may not cross-examine his own witness in an effort to impeach him.

Bushaw v. United States, 353 F. 2d 477 (9 Cir. 1965), cert. denied 384 U.S. 921.

Regardless of whether the defense had the right to cross-examine their witness, the Court has considerable discretion as to the permissible extent of examination.

Harris v. United States, 371 F. 2d 365 (9 Cir. 1967);
Enciso v. United States, 370 F. 2d 749 (9 Cir. 1967).

The record discloses an extensive examination into the motive for Mr. Cagle's testimony. There was no restriction whatsoever on any questioning regarding promises of leniency or any other expectation of Mr. Cagle. In the absence of any promise, Mr. Cagle's release subsequent to testifying is within the realm of speculative materiality. As the trial judge in the instant case pointed out, if in fact Mr. Cagle was released on his own recognizance after his testimony, it was a Court Order which could have been initiated by any one of many people and one can only assume that the Court did it upon a legal, legitimate reason [R.T. 1153].

Bomar v. United States, 270 F. 2d 329 (D.C. Cir. 1959), cert. denied 361 U.S. 936.

I. THE TRIAL COURT DID NOT UNDULY LIMIT PROOF OF LSD CONSUMPTION.

Appellants Rice and Toroker testified in great detail to their use of LSD and specifically that they had used LSD on the dates of each transaction described in the indictment. Mary Lou Rice testified to the same general effect [R. T. 597]. In addition, the defense called Stephen Cole who testified that he saw Appellants Rice and Toroker take LSD during this period of time. However, Mr. Cole could not testify that either appellant used LSD on an indictment date or even that he saw the appellant on a day described in the indictment [R. T. 552-574]. The next defense witness, Linda Quante, was also offered to show prolonged usage of the drug and the defense volunteered to avoid any cumulative testimony [R. T. 577-578]. As to the third witness, Regina Champlain, the defense advised the court, "Your Honor, we had the same questions to ask of her, but she would also give cumulative answers, so we will refrain from asking the questions concerning the LSD and the use of it." [R. T. 591]. On redirect, the defense asked about the use of LSD by Appellants Rice and Toroker and an objection was sustained [R. T. 596].

The Government did not contest the fact that Appellants Rice and Toroker used LSD. Appellant Toroker was under the effect of LSD when his psychiatrist examined him. The psychiatrist testified he was sane at that time [R. T. 804]. This drug usage was relevant to the defense of insanity if appellants were under the influence of

LSD on the date and at the time of the offenses charged [R. T. 799]. The three witnesses aforedescribed could not testify to this fact thus, it was proper to sustain the objection to the question posed to Miss Champlain.

> "In the exercise of a sound judicial discretion, a Court may limit the number of witnesses permitted to testify to a single fact and the extent to which cumulative testimony may be received. It may be that in some instances particularly where a fact is not contested, a limitation to one witness is proper."
>
> Peterson v. United States, 268 F. 2d 87, 88 (10 Cir. 1959).

J. THE JURY WAS PROPERLY INSTRUCTED ON INSANITY.

Appellants specifically requested the instructions on insanity which were given by the Court below [R. T. 860]. After the instructions were read to the jury, appellants did not object to the insanity instructions [R. T. 1449].

Rule 30 of the Federal Rules of Criminal Procedure provides in part that "no party may assign as error any portion of the charge or admission therefrom unless he objects thereto before the jury retires to consider the verdict. . . ". Appellants' failure to object has foreclosed the right to review.

Phillips v. United States, 334 F. 2d 589 (9 Cir. 1964),

cert. denied 379 U.S. 1002.

Credibility was determinative of the issue of insanity in the instant case. Thus the given instruction was proper.

Kilpatrick v. United States, 372 F.2d 93 (9 Cir. 1967);

Maxwell v. United States, 368 F.2d 735 (9 Cir. 1966);

Sauer v. United States, 241 F.2d 640 (9 Cir. 1957), cert. denied 354 U.S. 940.

V

CONCLUSION

It is respectfully submitted that for the reasons stated, Judgments of Conviction should be affirmed.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

/s/ JO ANN DUNNE

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No. 21172

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ALAN HARVEY RICE, LAWRENCE STANFORD TOROKER, EDDIE JAVOR,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLANTS' CLOSING BRIEF.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

No. 21172

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Alan Harvey Rice, Lawrence Stanford Toroker, Eddie Javor,

Appellants,

vs.

United States of America,

Appellee.

APPELLANTS' CLOSING BRIEF.

The Procedures Used in the Court Below Were Inadequate to Insure a Reliable and Clear Cut Determination of the Voluntariness of the Rice and Toroker Confessions, Including a Clear Cut Resolution of Disputed Facts Upon Which the Voluntariness Issue May Depend.

The Court below did not make a full and reliable determination as to whether or not the confessions of Rice and Toroker were voluntary or involuntary. It rather abdicated its responsibility in this regard to the jury and made no finding on the question of voluntariness. As stated by the United States Supreme Court in *Jackson v. Denno,* 378 U.S. 368, 390-391 (1964):

> "Where pure factual considerations are an important ingredient, which is true in the usual case, appellate review in this Court is as a practical

matter, an inadequate substitute for a full and reliable determination of the voluntariness issue in the trial court and the trial court's determination, pro tanto, takes on an increasing finality. *The procedures used in the trial court * * * must, therefore be fully adequate to insure a reliable and clear cut determination of the voluntariness of the confession including the resolution of disputed facts upon which the voluntariness issue may depend.*" (Emphasis supplied).

"The District Court was required to make a finding on the record with 'unmistakable clarity' that * * * the confession or statement was freely and voluntarily made". *Evans v. United States*, 375 F. 2d 355, 360 (8th Cir. 1967). See also *Sims v. Georgia*, 385 U.S. 538 (1967).

In this instant case the court below, after recognizing that the question of whether or not the confessions were voluntary was a question of fact [Rep. Tr. pp. 468-469], did not attempt to resolve these issues, and therefore it could make no appropriate factual findings thereon [Rep. Tr. p. 479].

The Respondent cites a statement of the court at (Resp. Br. p. 13) ("the Court has to be convinced first of all that it is a voluntary confession, *or that the jury may reasonably consider it as a voluntary confession.* Then it becomes a question for the jury to determine * * *") (Emphasis supplied by the Appellant), to indicate the court's awareness of its responsibilities. It is urged by the appellant that what is indicated is the court's misunderstanding of its functions. This Honorable Court's attention is directed to

the underlined portion of the Court's statement where it clearly states its belief that "if the evidence presents a fair question as to its voluntariness as where certain facts bearing on the issue are in dispute or where reasonable men could differ over the inference to be drawn from undisputed facts, the judge 'must receive the confession and leave to the jury under proper instructions the ultimate determination of its voluntary character and also its truthfulness'" (*Jackson v. Denno, supra,* at 378 U.S. 377.) This quoted procedure which the court below accepted as its own concept of the law reflects the very procedure which was declared unconstitutional in *Jackson v. Denno, supra.*

The respondent goes on to say that "the court accepted that the confessions were admissible as voluntary." (Resp. Br. p. 13). It is respectfully submitted that no such finding was ever made with the "unmistakable clarity" required. The only thing the court did was to state on two occasions outside the presence o fthe jury [Rep. Tr. pp. 477, 479] that there is a conflict in the evidence which must go to the jury and that the jury must decide. The court also told the jury that it had made no decision on voluntariness and was giving them the entire question to decide [Rep. Tr. p. 515]. This, of course, was the absolute truth as evidenced by the court's same statement out of the jury's presence.

In its brief (Resp. Br. p. 14) the respondent attempts to explain away the court's remarks to the jury by asserting that they were only made to protect the record. Surely the respondent is not suggesting that the court made a deliberate and unnecessary misstatement to the jury!

There Was No Stipulation or Agreement as to the Narcotic Content and Chain of Custody of Certain Government Exhibits.

In all candor a reading of the Reporter's Transcript at pages 76 and 77 would tend to indicate that the Government and appellants were going to enter into some stipulations regarding the narcotic content and chain of custody of certain *undescribed* exhibits. It must, however, also be noted in fairness to the appellants that this vague agreement was prior to any of the exhibits being identified by exhibit number or content as the agreement referred to in the respondent's brief (p. 21) precedes any identification and marking of exhibits.

The Government actually began its *proposed* stipulation on the lower portion of Reporter's Transcript page 77 and was interrupted by the Court [Rep. Tr. pp. 77-78], Mr. Sobel [Rep. Tr. p. 79], and Mr. Lambros [Rep. Tr. p. 80] with questions by each that indicated a lack of agreement in which areas the record does not reflect concurrence by all defense counsel and the Government.

Government counsel was well aware that the proposed stipulation had not yet been made at Reporter's Transcript page 80 when she answered a question of Mr. Lambros about whether she was offering the exhibits into evidence, by stating:

> "After you have agreed to the stipulation I will offer the documents and their contents."

In any event the stipulation as to narcotic content was never effected or really even clearly offered, and there was no proposed stipulation on the chain of custody regarding the exhibits.

Black's Law Dictionary defines the word "stipulate" as follows: "Arrange or settle definitely, as an agreement or covenant", citing *Mennan Co. v. Krauss Co.*, 37 Fed. Supp. 161, 163 (E.D. Lou. 1941). Surely there was no *definite* settlement or agreement in this case. If this were a civil suit, would an action for breach of contract be won by the Government? Of course not; and it is implicit that the burden of the Government is even greater in a criminal action. Black's Law Dictionary, in defining the term "stipulation" states:

> "An agreement between counsel respecting business before the Court. *It is not binding unless assented to by the parties or their representatives* and most stipulations are required to be in writing" (Emphasis supplied).

citing *Holland Banking v. Continental*, 9 Fed. Supp. 988, 989 (W.D. Miss. 1934). There was no assent, and, therefore, there was no stipulation as to narcotic content or chain of custody.

The case cited by respondent, *McBain v. Santa Clara Savings*, 241 Cal. App. 2d 829, 838 (1966), is a situation where the plaintiff and one defendant entered into a *complete* stipulation as to what the testimony of one of the stipulating attorneys would be if he were called as a witness. During the discussion regarding this stipulation, one of the counsel for another defendant remained silent and later contended he was not bound. The Court ruled that he was in that case, in which ruling the appellant might well concur; but in our case there was no definite agreement between any

of the parties. In the case cited, the Court actually stated that:

> "A stipulation is an agreement between counsel respecting business before the court . . . and like any other agreement or contract, it is essential that the parties or their counsel agree to its terms."

The respondent in its brief points out that several of the exhibits were subjected to the Marquis Reagent test, which is a field test to determine the presence of an opiate, and gave a positive result indicative of the presence of an opiate (Resp. Br. p. 22). In the first place it was never established that the Marquis Reagent test is a reliable test for use in court. Secondly the men administering the test were never qualified as experts. Even if we were to assume that the test were valid and its administrators experts, what does it prove? Merely that the substance contains opium, morphine, heroin, or an opiate derivative [Rep. Tr. p. 101]. The defendants here were all charged with either heroin, cocaine or marijuana [Rep. Tr. p. 1430], and the jury was told that heroin and cocaine are narcotic drugs within the meaning of the statute [Rep. Tr. p. 1431]; but how about opium, morphine, or an opiate derivative that is manufactured in Los Angeles as morphine is? What are opium derivatives, and is it possible that some are harmless non-narcotics?

It is submitted that obtaining a proper stipulation on the narcotic content and chain of custody, in the absence of proper expert testimony, which shows an understanding waiver of a defendant's rights is not too great a burden on the United States Government or the administration of justice. The court below instructed the jury and properly so, that an essential element of the

crime was proof that the exhibits were heroin, cocaine and marijuana and the government had to prove each essential element of the crime beyond a reasonable doubt [Rep. Tr. p. 1432]. In other words before the government could convict it was obligated to prove the narcotic content of the exhibits. If an accussed does not face the government to its proof he is giving up the right to make the government prove an essential element of its case. A stipulation *re* narcotics content and claim of custody is therefore the equivalent of consenting to a search and the courts insist upon a clean and understanding waiver of a defendant's rights before such a waiver will be given effect.

The Court's Instructions on Entrapment Did Constitute Prejudicial Error.

The respondent first states that because the appellants denied the commission of the offenses charged against them in certain counts in the indictment, they are not entitled to the defense of entrapment, citing *Ortiz v. United States,* 358 F. 2d 107 (9th Cir. 1966), and *Ortega v. United States,* 348 F. 2d 874 (9th Cir. 1965).

A reading of the record with particular attention to those portions of the reporter's transcript cited in the respondent's brief (Resp. Br. pp. 13-14), reveals that Rice and Toroker are really not denying any of the offenses in the indictment, but only equivocating with the agents' testimony on several facts. They do not deny the fact that they sold heroin and cocaine to Government agents, which is the real gravamen of this case, but rather admitted these sales (receiving, transportation and concealment) charges, with some factual

differences in their testimony which the respondent is now attempting to make into a denial of specific charges —which never was the case. *United States v. Ortega, supra,* at 876 (Headnotes 2 and 3). It must also be noted that in the cases cited by the respondent the instruction on entrapment was not given as it was in this case, so the issue is really quite different.

While it is certainly true that ordinarily a party who requests a certain instruction is hardly in a position to object to that instruction, we have a different situation in our case because the defendants were entitled to assume that the time-honored court instructions which was requested was the only one the court would consider. *Robison v. United States,* .... F. 2d .... (9th Cir. No. 20752) does not stand for the proposition cited by the respondent because in that case the instruction was substantially the same as in *Notaro v. United States,* 363 F. 2d 169 (1967), and the jury was properly instructed by the court on burden of proof, whereas in our case it was not.

In any event the appellants are at least entitled to the instruction they requested and not one which completely leaves out the proper wording regarding "predisposition" to commit crime and the particular burden of proof with regard thereto. If the learned and conscientious judge in the court below accidentally misread the form instruction, then surely defense counsel cannot be blamed for making a similar error to their clients' prejudice. This is a perfect example of plain error, Federal Rule of Criminal Procedure 52(b), which is not cured by the failure to object.

The Evidence of Javor's Other Crime Was Irrelevant in That It Was Highly Prejudicial and Unrelated to the Crimes for Which Javor Was Being Tried.

The respondent contends that its *deliberate* introduction before the jury of Javor's other crime was perfectly reasonable to show "knowledge of transporting heroin on that occasion and his lack of innocent purpose for the trip to Tijuana" (Resp. Br. p. 17), citing *Reed v. United States,* 364 F. 2d 630 (9th Cir. 1966).

The appellant has no quarrel with the holding of *Reed v. United States, supra,* at page 633 that:

> "Evidence of other crimes, despite its prejudicial effect, is admissible to establish motive if it is of *high relevance.* McCormick, *Evidence,* Section 157 p. 330 (1954)" (Emphasis supplied.)

A reading of McCormick's text reveals the same high relevance requirement for knowledge and lack of innocent purpose. The examples cited in that eminent author's book on the point in question illustrate that the measure of relevance here is not that required by either McCormick or the above-cited case.

It is interesting to note that the respondent in its brief does not even allude to the appellant's argument that the reason this evidence was ever admitted by the court below was because of an offer of proof which was made by the Government and then never submitted to the jury (App. Br. pp. 21-22).

In *Diaz-Rosendo v. United States,* 364 F. 2d 941, where the defendants were charged with conspiring to import marijuana and of aiding and abetting smuggling marijuana, wasn't the marijuana found in the

car they were driving more relevant than Javor's failure to register at the border?

For evidence of other crimes to be admissible, it must be highly relevant "and should be excluded even though relevant if the value of the evidence is limited and the anger of prejudice from its use is great." *DeVore v. United States,* 368 F. 2d 396, 398 (9th Cir. 1966).

Eddie Javor Did Not Have Either Actual or Constructive Possession of the Narcotics in This Case.

The appellant in its opening brief contended that the record does not support a finding of actual or constructive possession in this case and therefore the court's intructions on the inference arising from possession and aiding and abetting constituted reversible error (App. Br. p. 28). In response thereto the respondent stated that Javor was the supplier of the heroin, that he had actual possession of it when he gave the narcotics to Mr. Cagle in Tijuana, and that a later telephone conversation showed Javor had joint constructive possession of the heroin when it was sold to Federal agents on June 7, 1965 (Resp. Br. p. 23).

A review of the record in this case reveals that the respondent's contentions are not sustainable even given the favorable inferences which attach to the government's evidence on appeal.

Cagle testified that Javor showed him "a bag containing two prophylactics and with some sort of something in it" [Rep. Tr. p. 157]. Javor told him it was "*cocaine*" [Rep. Tr. p. 158]. After they got back to Los Angeles from Tijuana Cagle returned the package

to Javor [Rep. Tr. p. 159]. Even though the testimony of Cagle is accepted at face value by this Honorable Court, it only establishes that on June 6, 1965 Javor caused to be imported into the United States two rubber contraceptives which he said were filled with "*cocaine*". That certainly does not prove that Javor had actual or constructive possession of the *heroin* which was sold to agents Salmi and Sherman on June 7, 1965. There is no chain of custody shown from Javor to Rice and Toroker for the narcotics Javor allegedly had Cagle bring across the border for him.

The alleged telephone conversation referred to by the respondent may be seen at Reporter's Transcript, page 282. Even if that highly unlikely conversation is to be believed, there is absolutely nothing therein to show that Javor ever had either actual or constructive possession of the heroin. At the very worst (from the appellant's point of view) it shows that Javor may have been involved as a conspirator, but not as one who possessed the heroin, *Hernandez v. United States,* 300 F.2d 114, 120 (9th Cir. 1962). The same argument should also apply to bring this case within the ambit of *Hill v. United States,* .... F. 2d ...., No. 21,126 (9th Cir. 1967).

Richard G. Sherman,
Sherman & Sturman,
Attorneys for Appellants.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

R. G. Sherman

No. 21,185

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

JOAN E. HELLER TRUST (FORMERLY
JOAN E. SMOTKIN TRUST),
ARIZONA TRUST CO., TRUSTEE, et al.,

PETITIONERS,

vs.

THE COMMISSIONER OF INTERNAL
REVENUE,

RESPONDENT.

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONERS

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INDEX

CITATIONS

Page

CASES:

STATUTES:

MISCELLANEOUS:

IN THE

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 21,185

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BRIEF FOR THE PETITIONERS

OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court dated November 18, 1965, (R.[1] 89), is reported in T.C. Memo. 1965-302, and the supplemental memorandum findings of fact and opinion of the Tax Court dated June 6, 1966, (R. 112), is reported in T.C. Memo. 1966-121.

[1] Transcript of Record, filed July 18, 1966.

1. The following proceedings are consolidated herewith: CAROLE D. SMOTKIN TRUST, ARIZONA TRUST CO., TRUSTEE; ROBERT E. HELLER and JOAN E. HELLER, husband and wife; HAROLD J. SMOTKIN TRUST, ARIZONA TRUST CO., TRUSTEE; and EDWARD E. and BETTY J. SMOTKIN, husband and wife.

JURISDICTION

The jurisdiction of this Court rests on Section 7482 of the Internal Revenue Code. Decision was entered by the Tax Court on March 18, 1966, determining deficiencies in Petitioners' Federal income tax returns for calendar years 1955, 1956 and 1957, in the total sum of $82,637.23, plus interest according to law, (R. 107-111). Petition for review by this Court was timely filed on June 13, 1966, (R. 116).

QUESTIONS PRESENTED

1. Taxpayers determined during the years in issue to liquidate their investment in 194 duplexes which they had previously held exclusively for rental purposes. (a) Did the Tax Court err when it held that taxpayers at the time of such liquidation were holding the duplexes primarily for sale in the ordinary course of their trade or business? In selling the duplexes taxpayers, as part of the consideration, received the purchasers' second contracts. (b) Did the Tax Court err in determining that such contracts had an *ascertainable* fair market value? (c) Where the only evidence before the Tax Court was an expert witness's testimony that these contracts were not negotiable and would not freely and easily pass from hand to hand in commerce in Arizona, did the Tax Court err in determining these contracts had an ascertainable fair market value and that they

would be freely negotiable at a discount of 50% of face value?

STATUTES INVOLVED

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include ——

> (1) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND VOLUNTARY CONVERSIONS.

[SEC. 1231(a)]

(a) GENERAL RULE. —— If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business . . . exceed the recognized losses from such sales, exchanges and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. . . .

* * * * *

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle. ——

* * * * *

(3) LONG-TERM CAPITAL GAIN. —— The

term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months.

* * * * *

SEC. 1202. DEDUCTION FOR CAPITAL GAINS.

In the case of a taxpayer other than a corporation, if for any taxable year the net long-term capital gain exceeds the net short-term capital loss, 50 per cent of the amount of such excess shall be a deduction from gross income. . . .

* * * * *

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) COMPUTATION OF GAIN OR LOSS. —— The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such Section for determining loss over the amount realized.

(b) AMOUNT REALIZED. —— The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. . . .

* * * * *

Internal Revenue Code of 1954.

STATEMENT

The facts found by the Tax Court, and the stipula-

tion of the parties adopted by the Tax Court, (R. 88), may be summarized as follows:

Petitioner Smotkin for many years was a resident of Columbus, Ohio.

In 1944, for reasons of his wife's health, Smotkin retired and moved to Beverly Hills, California. Thereafter he entered the photo-finishing business, which business was terminated in 1948 when he moved to Tucson, Arizona. In 1948 Smotkin formed a partnership with Bromley and with Jay Smotkin (petitioner's brother) under the name, American Homes Association, hereinafter called the partnership. After Jay was bought out in 1949, Smotkin had a two-thirds interest and Bromley a one-third interest in the capital, profits and losses of the partnership (R. 88d).

In February 1948, the partnership purchased an 80-acre tract of land near Tucson, Arizona, and by the latter part of 1949 or early 1950, the partnership had purchased two adjacent 80-acre tracts of land. During the period from 1948 to June 30, 1951, this partnership built and sold approximately 500 dwelling houses on two of the 80-acre tracts, (R. 88d).

The partnership built no homes for resale after June 30, 1951, (Trans.[2] 30).

In July 1951, the partners determined to meet a need for wartime rental housing in Tucson area by the construction of rental duplexes on the third 80-acre tract, (Trans. 18).

In accord with their decision, the partners proceeded, in 1951, to, (R. 88d):

(a) Incorporate American Homes Association as the rental management corporation.

[2] Transcript of Testimony, dated March 2, 1965.

(b) Incorporate American Building Company as the building corporation.

(c) Incorporate six rental corporations to hold the rental property. (American, National, Federal, Joan, Harold and Carole Rentals). The stock in these corporations was issued one-third Bromley, one-third Smotkin, and one-third Bromley as Trustee for Smotkin's children.

Construction was commenced in late 1951, and by July 14, 1952, 194 duplexes (388 dwelling units) had been completed, (R. 88e). Construction financing was obtained through private individuals, the Southern Arizona Bank and Trust Company, Tucson, and the Arizona Trust Company, Tucson. These loans were secured by duplex lots, personal guarantees of the partners and other real estate, including personal residences owned by the partners. The permanent financing was obtained from banks, savings and loan associations, trust and insurance companies. On some of these loans, the personal guarantees of Smotkin and Bromley were required, (R. 88g).

On April 20, 1952, Arizona Trust Company, Tucson, Arizona, took over as successor Trustee from Bromley, the trusts for the benefit of Smotkin's children. The Arizona Trust Company served as Trustee during all of the years here in issue, (R. 88e).

The construction price charged by American Building Corporation to the rental corporations was \$12,600.00 per duplex, which sum included coolers, venetian blinds, stoves and refrigerators for each unit. The \$12,600.00 figure was also the sum of the permanent mortgage on each duplex. (The \$12,600.00 represented 80% of the F.H.A. appraised value). The land was reflected on the rental corporations' books at \$200 per duplex lot,

making a total cost of $12,800.00 per duplex, (R. 88g). American Building Company was liquidated in January of 1953, (R. 92).

On January 2, 1952, a management agreement was executed by American Homes and the six rental corporations under which American Homes agreed to manage the 194 duplexes owned by the rental companies, to act as rental and operating agent and collect rentals, to advertise the properties for rental, and to maintain and repair the properties, (R. 93). It was agreed that American Homes would receive a commission of ten percent of gross rentals during 1952, and 20 percent of gross rentals after January 1, 1953, and would pay all expenses in connection with the advertising, leasing, maintenance and repair of the properties, (R. 93).

During 1953, the occupancy rate of the duplexes was about 65 percent, while during the years 1954 and 1955 the occupancy rate was about 72 percent. The financial statements of the rental corporations during the period 1953 through 1955 show substantial and consistent losses. During the first three and one-half months the duplexes were rented, they were rented by written lease agreements. Thereafter, they were rented on an oral month-to-month basis, (R. 94).

In an attempt to increase tenant occupancy, petitioner Smotkin, in January of 1954, proposed a swimming pool be built, and that 120 of the units be furnished. Since the cost of these additions would exceed $120,000.00, and since it would involve personal guarantees and mortgaging of other personal assets, Bromley refused to agree, and Smotkin and Bromley separated by the exchange of assets and cash, (R. 94). After this exchange, ownership of the six rental corporations and American Homes Association became one-third peti-

tioner Edward E. Smotkin, one-third petitioner Betty J. Smotkin, and one-third Arizona Trust Company as Trustee for the three Smotkin children. In the separation agreement, petitioners Edward E. Smotkin and Betty J. Smotkin agreed to indemnify and save harmless from any and all obligations and liabilities in connection with the duplex rental project, including any personal liability on the guarantees made in connection with the Prudential Life Insurance permanent mortgage financing, (Ex. 58).

American Homes Association proceeded, in 1954, to build the swimming pool and purchase furniture for 120 rentals, (Trans. 22). However, the vacancy rate remained high, the rental corporations continued to incur heavy losses and rental income was not sufficient to meet mortgage payments, (Trans. 22).

Early in 1955, Mr. Smotkin's health deteriorated. He developed a heart condition known as paroxysmal auricular tachycardia, which attacks were accompanied by a sudden and rapid heart beat, by lightheadedness, general malaise and anxiety. The attacks would last from 5 minutes to 12 hours. He developed ulcers of the duodenal, and suffered from nervous tension. He was referred to a cardiovascular specialist in San Francisco by his Tucson physician, Dr. Stephens. He was seen by Dr. Stephens twenty-five times during 1955. He was hospitalized in Tucson in the Fall of 1955 for treatment of his ulcer. Both the Tucson and San Francisco doctors concluded, with regard to Mr. Smotkin's health problems, that "business problems are primary," (Ex. 77).

In the Fall of 1955, Mr. Smotkin determined that it was impossible to hold the duplexes for rental, and that it would be necessary to liquidate his investment, (Trans. 26).

On September 1, 1955, the six rental corporations were liquidated and 186 duplexes were distributed to the stockholders in liquidation. The remaining eight duplexes had been sold between June 1, and August 31, 1955. American homes served as selling agent for the stockholders and proceeded as rapidly as possible to sell the duplexes, (Ex. 62). Commencing on or about November 1, 1955, the duplexes were advertised for sale. Prior to that, for over three years the duplexes were advertised only for rent, (R. 95). American Homes employed extensive newspaper and radio advertising as part of its selling efforts, (R. 88i).

American Homes also offered the free use of the pool for a temporary period to a purchaser of a duplex and his tenant. The pool agreements formed a part of the original contracts of sale, (Ex. 73). The books and records of American Homes show that owners and tenants of the duplexes were not charged for pool service until May 1, 1958. A typical pool agreement stated that after a cut-off date the pool privilege would be optional to the owner and his tenants at a specified annual price. After the sale of duplexes and during the years in issue, American Homes acted as rental agent for some of the new owners, (R. 95).

The free rental service was to be provided for a five-year period, and was so provided by American Homes. In addition, American Homes provided free garbage collection service for a limited period of time to owners of duplexes and their tenants, (R. 95-96).

During the period 1955 to 1958, 169 duplexes were sold. The remaining 17 duplexes were exchanged in 1956 for a cattle ranch. Approximately 55 of the duplexes were sold furnished. Most of the duplexes were sold at prices ranging from about $15,000 to about

$16,200. A typical sale would be handled in the following manner:

FHA mortgage assumed by purchaser	$11,419.98
Cash down payment	1,100.00
Contract	2,710.02
Total sales price	$15,230.00

The contract ($2,710.02 in the above example) executed by the purchaser provided for interest of 6 percent per annum and required payments of principal and interest totaling $25 per month, with the entire contract sum due in five years. If the sale involved a furnished duplex, then the contract would require a payment of principal and interest totaling $45 per month, $20.00 of which went to American Homes for the furniture, (R. 96).

In 1956 Smotkin obtained a real estate broker's license as a designated broker for American Homes; such license has been renewed annually to the present time. Smotkin is a member of the National Board of Realtors and the Tucson Real Estate Board, (R. 97).

In the period 1956 - 1962, petitioners reflected on their income tax returns, eleven casual sales of property which in most cases they had held for several years. (Two of the sales involved ranch property traded on several of the duplexes, (R. 97).

In the period June 1951, to September 1955, (the period of holding the duplex rentals) the taxpayers had no real estate purchase or sale activity, (Trans. 30; Ex. 3-7).

Taxpayers on their Federal income tax returns for the years in issue, reported the gains realized from the

sale of the duplexes as long-term capital gains, (Ex. 7-10).

Taxpayers (who were on a cash basis) considered the contracts received by them from the purchasers of the duplexes as having no ascertainable fair market value, and, accordingly, reported the payments on the contracts as income only in the year in which the payments exceeded their adjusted basis.

The Tax Court held that the taxpayers from the very outset were prepared to rent or sell the duplexes, and that at the time of the sale they were held by taxpayers in the ordinary course of their trade or business, citing as its sole authority, *Malat v. Riddell*, 347 F.2d 23 (C.A. 9th), which was then on certiorari to the Supreme Court, (R. 101).

The Tax Court further held that the second contracts received from the purchasers had a fair market value when received equal to 50% of their face value, and that they were includible in taxpayers' taxable income at such value in the year of sale.

SUMMARY OF ARGUMENT

I. The Tax Court erroneously found that taxpayers, who constructed and held 194 duplexes exclusively for rental purposes, were holding such duplexes for sale in the ordinary course of a trade or business when they determined to liquidate their investment. The evidence is that the duplexes were offered for rental for a period of three years and that the taxpayers finally determined to sell them after incurring substantial and continuous losses. The Tax Court erroneously found that the primary business of taxpayer was selling houses to customers. The uncontradicted evidence is that from 1951 down to the present time taxpayers constructed

no houses (other than the duplexes in question), sold no houses (other than the duplexes in question) and were engaged in a number of other businesses, including the garage and furniture business. While the Tax Court was deciding this case, the Supreme Court decided *Malat v. Riddell*, 383 U.S. 569. The Tax Court failed to follow the direction of the Supreme Court and did not make a determination of whether these duplexes were acquired "principally" for sale, or whether their sale was "of first importance." Instead, the Tax Court concluded that when renting was abandoned (assuming a dual holding of for rent or for sale) they must have been held for sale because taxpayer was in the business of selling houses. This is not the test set forth in *Malat*.

II. In the sale of the duplexes, taxpayers received as part of the consideration, the second contracts of the purchasers. Taxpayers treated the contracts as having no ascertainable fair market value and did not take payments thereon into income until received. The Commissioner had determined that the contracts had a value of 50% of face, and took such sum into income in the year of sale. The only person to testify on this issue, an expert witness offered by the taxpayers, testified that the contracts had no ascertainable fair market value on the dates received. The Tax Court with no supporting factual basis adopted the 50% of face value.

ARGUMENT

I. THE TAX COURT ERRONEOUSLY DETERMINED THAT TAXPAYERS WHEN THEY DECIDED TO LIQUIDATE A MONEY-LOSING RENTAL INVESTMENT HELD FOR OVER THREE YEARS, WERE (WHEN THEY DETERMINED TO SELL) HOLDING SUCH PROPERTY FOR SALE TO

CUSTOMERS IN THE ORDINARY COURSE OF THEIR TRADE OR BUSINESS.

From 1948 to 1951 Taxpayer Smotkin was an active builder of homes for sale in Tucson, Arizona, (R. 92). Such sales were reflected in his tax returns as ordinary income, (Trans. 43). In 1951, Smotkin and his then partner, Bromley, determined to construct rental duplexes and keep them permanently as an investment, (Trans. 19). They proceeded to construct 194 duplexes for rental purposes, (Trans. 20). The partners decided at the same time to get out of the business of building homes for sale, and as a matter of fact from 1951 down to the present time neither taxpayer Smotkin, nor any of the other taxpayers have built any homes for resale in Tucson, Arizona, or elsewhere, (Trans. 30). From the time of construction of the rental duplexes in 1951 until November 1, 1955, the duplexes were offered only for rent and not for sale, (R. 88i). The F.H.A. Regulations under which taxpayers built, allowed them to build for sale or rent, as they might choose, (Trans. 31). Their choice was to rent all of them.

The rental program was not successful. In spite of heavy borrowings for the construction of a swimming pool and the furnishing of 60 duplexes, the occupancy rate remained at the sixty to seventy percent level, (Trans. 22). From 1952 to 1955, the rental corporations suffered losses in excess of $162,000.00, (Ex. 46). In addition, American Homes Association, the rental agent, during the same period suffered losses in excess of $100,000.00, and it was engaged in no other business activity, (Ex. 35-38). These business reverses led to a breakdown in taxpayer Smotkin's health, (Trans. 25; Ex. 77). The taxpayers, under these conditions, found it impossible to retain the duplexes for investment purposes, and they entered into a program of liquidation,

(Trans. 26). Once they determined to liquidate, the duplexes were sold as rapidly as possible, and in the period from the middle of 1955 to August of 1957, the duplexes were sold, (Ex. 62). Since 1957, taxpayer Smotkin has been in the garage and furniture business and the rental of commercial frontage and stores, (Trans. 33). It was not until 1956 that American Homes Association, the selling agent, obtained a broker's license. None of the taxpayers held a broker's license except Mr. Smotkin, who had held one for a short while in Columbus, Ohio in the early 1940's, (Trans. 29).

Based upon these facts, the Tax Court held in its memorandum opinion filed November 18, 1965, that: "the sales of the duplexes in the years in issue did not represent the liquidation of an investment as contended by the petitioners, but instead were sales of property in the ordinary course of business." (R. 99).

The Tax Court reached this legal conclusion from their finding that: "from the very outset petitioners were prepared to either rent or sell these 194 duplexes whichever proved the most profitable course of action . . ." (R. 101). This finding then brought the case, in the Tax Court's view, in full accord with *Malat v. Riddell,* 347 F.2d 23 (C.A. 9th), which was the only case it cited or quoted, (R. 101). At the time of the Tax Court's memorandum opinion of November 15, 1965, certiorari had been granted in *Malat,* (R. 101). Certiorari was granted to resolve a conflict between the various Circuit's interpretation of the word "primarily" as used in Section 1221. (See *Municipal Bond Corp. v. Commissioner,* 341 F.2d 683 (C.A. 8th).

Appellants moved the Tax Court to postpone entry of decision pending Supreme Court action which was promptly denied, and on March 18, 1966, decision was

entered. The Supreme Court entered its decision vacating and remanding *Malat* on March 21, 1966. (383 U.S. 569) On June 6, 1966, the Tax Court in the instant cases filed a supplemental memorandum findings of fact and opinion, (R. 112). In its supplemental memorandum the Tax Court affirmed its prior conclusion and sought to explain the legal standard used in arriving at its conclusion. It first attempted to distinguish factually the instant cases and *Malat* by saying that in the instant cases, the taxpayers' "business was primarily the development of tracts of realty for sale to customers in the ordinary course of its business," while in *Malat* the partnership, "for some time had been engaged in the purchase and development of real estate for rental." (R. 114). It went on to say that when speaking in its original opinion, that these taxpayers intended at the outset to rent or sell, it had in mind a taxpayer whose primary business was developing houses for sale, (R. 114).

The Tax Court's conclusions in these cases are clearly erroneous, factually and legally. The Tax Court's interpretation of *Malat* is in error both factually and legally.

Against an overwhelming sum of contrary evidence there are two facts that the Tax Court relies on in concluding that in the duplex sale period, 1955 through 1957, taxpayers were in the primary business of developing houses for sale.

The first of these facts is that taxpayers at the outset intended to rent or sell, whichever proved the most profitable, (R. 101), and this is alleged to be proved by the fact that the 1952 application taxpayers filed for F.H.A. mortgage insurance on the duplexes, (Ex. 56), contained the following question and response: "Do

you intend to occupy, rent or sell this property?" The taxpayers answered the question, "rent." Part of the same question, which asked for the proposed sale price, (if for sale), taxpayers gave a price of $15,750.00. We have attached a copy of this document to the appendix, (Exhibit 56DDD, Appendix, infra). We believe that the most that can be said for this document is that it is inconclusive as showing any specific intent to rent or sell. Under these circumstances we think the document's real meaning, and the taxpayers' intent, must be found in other evidence. The other evidence is:

(a) That the duplexes were offered only for rent for a period of three years. They were not offered for sale until the liquidation began in the Fall of 1955, (R. 88i.)

(b) Not one duplex was sold until almost three years after renting commenced, (Ex. 62).

(c) A rental management contract was entered into between American Homes Association and the rental corporations, (R. 88h).

(d) Taxpayers spent, during the rental period, $120,000 on a swimming pool and the furnishing of 60 duplexes, (Trans. 22, 23). Surely no one whose true intent was to sell would, in the middle of the rental period, invest $120,000 in a pool, and furniture for tenants.

(e) The taxpayer's own testimony, that he intended to quit building houses for speculation and to build these rental duplexes for retirement income, (Trans. 19).

(f) A real estate broker's license was not obtained by taxpayers, or any of their corporations, until 1956 after liquidation began, (Trans. 29).

(g) The determination to sell the duplexes was based upon factors not present when they were first rented three years earlier, and when the duplexes were finally sold there existed excellent reasons for such sale:

(1) Business: losses in the rental corporations of over $162,000, (Ex. 46). Losses in the rental management corporation of over $100,000, (Ex. 35-38).

(2) Personal: The deterioration in Mr. Smotkin's health, (Trans. 25; Ex. 77).

The other fact emphasized by the Tax Court in its supplemental memorandum is that in years prior to the construction of the duplexes, taxpayers had built and sold some 500 houses. From this they concluded: "the ultimate sales during the years in question can well be said to be within the every day operation of a business that was primarily selling houses to customers," (R. 114). The overwhelming contrary evidence is:

(a) During the period 1948 to June 30, 1951, taxpayer Smotkin did build and sell approximately 500 houses, but he testified that commencing in 1951 he intended to quit building houses for speculation, and to build the rental duplexes for retirement income, (Trans. 22).

(b) The evidence shows that except for the duplexes in question, the taxpayers, or any of their corporations, did not build or sell one house from the period June 30, 1951, down to the time of the trial of this case. They did not build or sell any houses during the duplex rental period, 1952 - 1955, (Trans. 30). They did not build or sell any houses during the liquidation period 1955 - 1958, (Trans. 30). They did not build or sell any houses in the post liquidation period 1957 - 1965, (Trans. 30). Surely these facts cannot possibly

lead to a conclusion that this was "within the everyday operation of a business that was primarily selling houses to customers."

(c) Subsequent to the duplex liquidation, American Homes Association was engaged in the construction of commercial rental property, Mr. Smotkin was engaged in the rental of commercial property, the garage business, the furniture business and the auto parts business, (Trans. 33, 40).

(d) Paragraphs (f) and (g) above, are also pertinent to this issue.

We believe these facts clearly show that the primary purpose for building the duplexes was for rental purposes and that the sale some three years thereafter was not inconsistent with this original purpose. Except for the two facts noted above, which are as we have stated most inconclusive, there is not one document or word of testimony to support the Tax Court's finding that taxpayers' everyday business was selling houses.

We believe the instant case is squarely within the language of this Court, when in *Malat* it stated, 347 F.2d 23, at 26, (C.A. 9th): "In such a case as this the purpose of the holding is undoubtedly difficult of ascertainment, *where an investment program has been followed through it is there for all to see.*" [Emphasis supplied]. See also *Palos Verdes v. U.S.*, 201 F.2d 256 (C.A. 9th).

In spite of the contrary evidence, if it is assumed *arguendo* that the Tax Court was correct in its finding that the primary business of these taxpayers was the development and selling of houses, it failed to apply the correct legal standard to this finding. The Tax Court stated, (R. 114):

> "When we say in our opinion that petitioner intended at the outset to either rent or sell these houses, whichever proved more profitable we are talking of a taxpayer whose primary business was developing and selling houses and who was about to rent some of its houses, and if renting proved unprofitable then it would be abandoned as a business endeavor and the houses . . . would be held primarily for sale. . . ."

This of course is not the issue. The issue is for what purpose were they holding these particular duplexes and was that purpose their primary purpose. *Malat v. Riddell,* 383 U.S. 569. It is not enough for the Tax Court to say that they were in the business of building and selling houses, that they built these duplexes to sell or rent, and that when they determined to sell, it became their primary purpose, and thus was in the ordinary course of their trade or business. Under the Tax Court's reasoning, these duplexes could never be sold as the liquidation of investment property —— even if they were held for rent for 30 years. Its reasoning is that since taxpayers' primary business was building houses, and they built these to rent or sell, when they abandoned the rental, selling by some magic becomes the primary purpose. This is not the law. If it were, a homebuilder could never hold houses or duplexes for investment. The essential findings never made by the Court, were those findings necessary to support its legal conclusion that *these duplexes* were primarily being held for sale. To arrive at this conclusion the Tax Court would have had to find that when the duplexes were constructed, taxpayers had a dual purpose (renting or selling), but that selling was their primary purpose. This they could not possibly find because of the uncontradicted evidence of renting for three years.

The Tax Court committed further error when it stated in its supplemental memorandum:

> "We think the houses in question were being held *after* late 1955, for sale to customers in the furtherance of the primary business purpose of the petitioner, which was that of developing real estate and selling houses." [Emphasis supplied.] (R. 115)

The critical event is the purpose of the holding, and it is not the actual sale which governs. *United States v. Bennett,* 186 F.2d 407, 410-411, (C.A. 5th); *McGah v. Commissioner,* 210 F.2d 769 at 772, (C.A. 9th); *Municipal Bond Corp v. Commissioner,* 341 F.2d 683, 689 (C.A. 8th).

3B *Mertens Law of Income Taxation,* § 22,138, ¶ 628-629, states the rule as follows:

> "If the taxpayers' situation is examined at the very moment the property is sold, it will invariably be found that there was an intent to sell, but such literal approach would nulify the statutory provisions conferring capital gain or loss treatment, and would seem to go beyond the legislative intent behind the exclusion involved."

The Tax Court's undue emphasis on taxpayers' 1948-1951 activity of building and selling single dwelling houses creates doubt as to whether the Court understands that not only can a taxpayer be previously engaged in holding property for sale to customers, and yet have investment property, but he can also hold property for sale at the same time he holds other property for investment. The Tax Court itself has recognized this rule many times. In *Municipal Bond Corp. v. Commission,* 46 T.C. 219 (on remand from the Eighth Circuit and pursuant to (*Malat*), it stated, (46 T.C. 219,):

> "Petitioner is a corporation whose sole business activity over a number of years has apparently been

> buying, holding, renting and selling real estate. While we recognize that a corporation may be an investor in real estate entitled to capital gains on the profits realized on the sale of such investment property, see *Randolph v. Rouse,* 39 T.C. 70. . . ."

The Rouse case cited by the Tax Court above, was acquiesced in by the Commissioner, (1963-2 Cum. Bull. 5). *Rouse* involved a taxpayer who was a developer and builder of houses for sale. In the years 1950-1953 he acquired from his building corporations some 40 houses which he held for rent. When the rental market deteriorated, he sold them in 1953, 1954 and 1955. The Tax Court in holding that he was entitled to capital gain on the sale, stated, (39 T.C. 70, 76):

> "On the facts here there can be little question but that petitioner purchased and held the 40-odd houses in the Great Forest and Bel Air subdivisions for investment and rental purposes, as we have found above. The fact that he rented most of them for periods of 2 years or more; *that he decided to go out of the rental business only after changes in real estate conditions made it unprofitable;* that he purchased no more houses for rent after that time; that he offered none of his houses for sale as long as he could rent them satisfactorily; and that the sale of the rental houses extended over a period of several years, as tenant occupancies failed, all tend to support petitioner's contentions that he acquired and held houses for rental purposes and not for resale. The record contains little evidence in support of the contrary view. The gains on the sales of the properties that were held for 6 months or more were property reported, we think, as long-term capital gains." [Emphasis supplied.]

In *D. G. Bradley v. Commissioner,* 26 T.C. 970, the Tax Court held that a person who was both an investor and dealer in real estate was not a dealer in real estate when he sold 24 houses in 1948 that he had built in 1946

and rented between 1946 and 1948. The Court stated he had valid reasons to sell in order to pay the expenses of his wife's illness, and to transfer his investments to a motel and dwelling units in Arizona. The Court stated, (26 T.C. 970, 979):

> "The facts indicated to our satisfaction that his decision to sell was based on these factors and that prior to the sales he was holding the property in question for rental investment purposes. The sales were incident to liquidation in order to transfer his holdings to other types of investment and to relocate in Arizona. Walter R. Crabtree, supra. The fact that his income from sales was greater than his income from rentals does not mean that all property sold was primarily for sale in the ordinary course of trade or business. Cf. Delsing v. United States, (C.A. 5, 1951) 186 F.2d 59, 61)."

In *Curtis Company v. Commissioner*, 232 F.2d 167 (C.A. 3rd), petitioner built, in 1944, 1098 units for rent. In 1946, the restrictions on their sale were removed and in 1947 he sold 851 units and the balance were sold in 1948 and 1949. The Court in holding that petitioner was entitled to capital gain stated, (232 F.2d 167, 169-170):

> "Is the taxpayer any worse off because it did the selling itself and by single parcels instead of job lots? We do not see how it can be fairly said so. With the concession that up to the very minute of decision to get out of the housing rental business the property was held for investment and with the undisputed fact that after the rental properties were sold the taxpayer turned its attention to other activities, we do not see that there is basis for saying that the regular course of its business, as to these houses, was real estate selling. We think it a case of one having an investment property on hand which he wants to turn into another form of investment. By the very nature of the case he had to sell the properties a piece at a time. Surely that does not make

him a 'dealer' in these parcels of land any more than it would make a man a dealer if he wanted to liquidate his holdings in a corporate stock for which the market was weak so that he had to sell by small parcels instead of by one sale. That is the taxpayer's situation here."

It would appear that the Tax Court is in conflict with itself in its undue emphasis of the prior building activities of taxpayer Smotkin, which building activities ended four years prior to the years in issue.

In summary, we would say that the Tax Court's conclusion that these duplexes were "being held after late 1955 for sale . . . to customers in furtherance of the primary business purpose of the petitioner, which was that of developing real estate and selling houses" was not a finding drawn from the evidence, but one induced by an erroneous view of the law.

II. THE TAX COURT ERRONEOUSLY DETERMINED THAT THE SECOND CONTRACTS RECEIVED BY THE TAXPAYERS FROM PURCHASERS OF THE DUPLEXES HAD AN ASCERTAINABLE FAIR MARKET VALUE.

Taxpayers received in the sale of the duplexes, second contracts payable \$25.00 per month (\$45.00 per month furnished), including interest, with the total sum due in five years. (The face amount of the second contracts was from approximately \$1,800.00 to \$4,000.00). They treated these as having no ascertainable fair market value, and did not take payments thereon into income until such payments were actually received. The Commissioner and the Tax Court determined that the contracts had a value of fifty percent of face, and took such sum into income in the year of sale.

Section 1001(b) of the Internal Revenue Code of 1954, provides in part as follows:

> "(b) AMOUNT REALIZED — The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

In *Johnston v. Commissioner,* 14 T.C. 560, the Tax Court held that a cash basis stockholder who received a contract for the sale of his stock in 1942 could not report the gain on his sale in 1942, but must report that gain in 1943, when the contract was paid off. The Court determined that he realized no gain on his sale until the amount realized exceeded his basis [citing *Burnet v. Logan,* 283 U.S. 404], and that the contract was not an "amount realized". The Court stated:

> "An agreement, oral or written, of some kind is essential to a sale. If payment is made at the same time that the obligation to pay arises under the agreement, then the profit would be reported at that time no matter which method was being used. However, the situation is different when the contract merely requires future payments and no notes, mortgages, or other evidence of indebtedness such as commonly change hands in commerce, which would be recognized as the equivalent of cash to some extent, are given and accepted as a part of the purchase price. That kind of a simple contract creates accounts payable by the purchasers and accounts receivable by the sellers which those two taxpayers would accrue if they were using an accrual method of accounting in reporting their income. But such an agreement to pay the balance of the purchase price in the future has no tax significance to either purchaser or seller if he is using a cash system." 14 T.C. 560 at 565.

Petitioners received no notes, mortgages or other evidences of indebtedness, (Trans. 33).

In *Ennis v. Commisisoner,* 17 T.C. 465, the Court determined that where property was sold under a con-

tract providing for a cash down payment and deferred payments over a period of years (not evidenced by a note or other evidence of indebtedness), the contract was not equivalent to cash and the only amount realized by the taxpayer in the year of sale was the sum of cash received. The Court stated, 17 T.C. 465, at 470:

> "In determining what obligations are the 'equivalent of cash' the requirement has always been that the obligation, like money, be freely and easily negotiable, so that it readily passes from hand to hand in commerce."

See also *Mertens Law of Federal Income Taxation*, Vol. 2, (1961 Revisions), § 11.05; 11.06.

In *Phillips v. Frank*, 295 F.2d 633, (C.A. 9th), this Court recognized the rule of the above cases.

The Tax Court's memorandum findings of fact and opinion cites no cases in support of its view that the second contracts had an ascertainable fair market value and that such value was 50% of the face. The Commissioner at the trial of this case offered no testimony expert or otherwise on value.

The only expert to testify was offered on behalf of the taxpayers, he was a well-qualified, (Ex. 79), M.A.I. appraiser. He testified as follows, (Trans. 59):

> "Q. Now, based upon your experience in this field and your examination of those sample contracts and the testimony here today, do you have an opinion whether or not these contracts would have been on the dates received freely and easily negotiable in Tucson, Arizona?
>
> A. Yes, I have such an opinion.
>
> Q. What is that opinion, sir?
>
> A. That these contracts were not negotiable and that they were not freely and easily negotiable

and they would not readily pass from hand to hand in commerce.

Q. Would they on the dates received have had an ascertainable fair market value?

A. No, sir, not in my opinion."

This was the only evidence before the Court on this issue. If, in fact, these contracts did have an ascertainable fair market value, or were readily negotiable in Tucson, Arizona, the Government could have called any number of Title Officers, Appraisers, Bankers or other persons qualified to so testify. *They did not do so.*

The weight to be given such evidence is set forth in *Roth Equipment Co. v. Gallagher*, 172 F.2d 452 (C.A. 6th), at page 455:

> " . . . The only direct evidence before the Court on the specific question of reasonableness of compensation was the testimony of Harold Hampton and Archie Shearer, both well-qualified, impartial witnesses, with many years of experience. They testified that in their opinion the compensation was reasonable, with Mr. Hampton referring to it as 'very reasonable'. The credibility of these witnesses was not put in issue. The appellee offered no witness to contradict this testimony or to testify in any way that the compensation was unreasonable to any extent. On this crucial and single issue of fact in this case this unimpeached, uncontradicted testimony from well-qualified, impartial witnesses can not be disregarded by the Court. This Court has several times stated that such testimony should be accepted by the fact-finder in a matter in which the fact-finder has no knowledge or experience upon which he could exercise an independent judgment. [citing cases] . . . "

There is no question that these contracts would not move freely and easily in commerce when consideration is given to the inducements given to purchasers which

endured beyond the sale date, such as free rental service for an extended period, free pool service and free garbage service, (R. 881; Ex. 73, 74). American Homes Association, as selling agent for the taxpayers offered the inducements and signed the Deposit Receipt and Sales Agreements with the purchasers, (Ex. 65, 69). There is no question that the obligation to fulfill these free services would attach to anyone who purchased the second contracts. It is a fundamental propostion of agency law that an agent's acts within the scope of his authority are the acts of the principal. Such authority may be confirmed by actual authority, implied authority and also from conduct, as stated in 3 Am. Jud. 2d, § 73 (p. 475):

> "The liability of the principal for acts and contracts of his agent is not limited to such acts and contracts of the agent as are expressly authorized, necessarily implied from express authority, or otherwise actually conferred by implication from the acts and conduct of the principal. So far as concerns a third person dealing with an agent, the agent's 'scope of authority' includes not only the actual authorization conferred upon the agent by the principal, but also that which has apparently been delegated to him."

It is, therefore, apparent that the pool agreements signed by American Homes Association at the time of the signing of Deposit Receipt and Sales Contracts were fully binding upon taxpayers.

The expert witness testified on cross-examination (over objection of taxpayers' counsel) as follows, (Trans. 66):

> "Q. Mr. Klafter, if I were to offer you that particular contract to buy, in other words, I offered to sell it to you, based upon your examination of these duplexes and of the property and without telling you that there are any other conditions out-

side the scope of this contract, would that contract be marketable? Would you be interested in buying it?

Mr. Ritcher: I object, Your Honor. It's a hypothetical question. It assumes facts are not in evidence which are in evidence.

Judge Mulroney: This is cross-examination. The Court allows the utmost latitude in cross-examining an expert. He may answer.

A. I would be interested in buying it only at a discount, not for face value."

From this improper question which asked the witness not to consider facts which were in evidence the Court was able to conclude that the contracts were marketable. The question became meaningless and irrelevant when the witness is asked to ignore conditions which in fact existed. It would be similar to asking a witness to value a contract which provided for interest only and no payment of principal for 20 years with the qualification that the witness was to ignore the absence of principal payments.

The error was further compounded. The witness was asked the price which *he* would be willing to pay for these purely hypothetical contracts. He stated that every contract would have to be valued on an individual basis and it would depend on a large number of individual factors including the purchasers' earnings, his equity, the price he paid, (Trans. 67). From this the Court was able to conclude that this large number of second contracts could have been sold in Tucson, Arizona, for 50% of their face value! The fact that this witness testified that he might buy a contract after investigation of the individual purchaser can not establish that there was an ascertainable market for 194 of the contracts in Tucson, Arizona.

Finally to buttress its conclusion the Tax Court adopts a negative inference based upon hindsight — it states, (R. 103):

> " . . . and, finally, there is no indication that the payments on these contracts (which had to be paid in full within a five year period) were not generally made as required."

This Court's case of *Phillips, et al. v. Frank*, 295 F.2d 629 (C.A. 9th) deals with a slightly different issue, but the language of the conclusion there seems most appropriate to the instant case, (295 F.2d 629, 633):

> "There is no evidence in the record that such rights had any market value, fair or unfair . . . "

CONCLUSION

The decisions of the Tax Court are erroneous and should be reversed.

Respectfully submitted,

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I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

DAVID W. RITCHER
Attorney

EXHIBITS

Number	*Identified*	*In Evidence*
1 - 77	Received by Court with Stipulation of Facts (R. 15)	
78	28	29
79	58	58
80 (zzz)	76	—
www	44	46
xxx	68	71
yyy	70	71

APPENDIX 56DDD ATTACHED

No. 21,185

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

JOAN E. HELLER TRUST, et al.,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE

TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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I N D E X

CITATIONS

Cases:

IN THE UNITED STATES COURT OF APPEALS

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No. 21,185

JOAN E. HELLER TRUST, et al.,

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (I-R. 89-106),[1] are not officially reported. The supplemental memorandum findings of fact and opinion (I-R. 112-115) are not officially reported.

JURISDICTION

This petition for review (I-R. 116-119) involves deficiencies in federal income tax for the taxable years 1955, 1956 and 1957 in the approximate amount of $82,600. On March 25, 1960, the Commissioner

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1/ "I-R." references are to Volume I of the record on appeal.

of Internal Revenue mailed to the taxpayers notices of deficiency asserting deficiencies in tax for the years 1955, 1956 and 1957 totaling \$163,320.10. (I-R. 7-11, 22-29, 40-47, 58-65, 76-84.) Within ninety days thereafter, on June 14, 1960, the taxpayers filed petitions with the Tax Court for a redetermination of these deficiencies under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-12, 16-30, 34-48, 52-66, 70-85.) The decisions of the Tax Court were entered March 18 1966. (I-R. 107-111.) The case is brought to this Court by a petition for review filed June 13, 1966 (I-R. 116-119), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTIONS PRESENTED

1. Whether the Tax Court was correct in deciding that the gains on the sales and exchange of duplex houses were taxable as ordinary income rather than capital gain because taxpayer 2/ held these properties primarily for sale to customers in the ordinary course of his trade or business.

2. Whether the Tax Court was correct in deciding that the deferred payment contracts executed by purchasers of the duplexes had a fair market value of 50 percent of face value and, to that extent, were includable in taxpayers' income in the year of sale.

2/ The Tax Court noted (I-R. 99, fn. 2) that it was only necessary to focus upon the activities of Smotkin since it was clear from the record that he was the dominant figure in the real estate ventures and any finding as to him was equally applicable to the other taxpayers. For the sake of convenience all references will be to Edward E. Smotkin as taxpayer.

STATUTES INVOLVED

Internal Revenue Code of 1954:

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) General Rule.--The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

*   *   *

(26 U.S.C. 1964 ed., Sec. 451.)

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) Computation of Gain or Loss.--The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount Realized.--The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized--

*   *   *

(26 U.S.C. 1964 ed., Sec. 1001.)

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

*   *   *

(26 U.S.C. 1964 ed., Sec. 1221.)

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

For purposes of this subtitle--

*　　　　　*　　　　　*

(3) Long-term capital gain.--The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

*　　　　　*　　　　　*

(26 U.S.C. 1964 ed., Sec. 1222.)

STATEMENT

The facts relevant to this appeal, as found by the Tax Court (I-R. 90-98), some of which were stipulated, are substantially as follows:

Edward S. Smotkin and Betty J. Smotkin, husband and wife, are residents of Tuscon, Arizona. They filed their joint Federal income tax returns for the years in issue with the District Director of Internal Revenue, Phoenix, Arizona. The Joan E. Heller Trust (formerly Joan E. Smotkin Trust), the Carole D. Smotkin Trust and the Harold J. Smotkin Trust are trusts created under the laws of the State of Arizona. The trustee of all the trusts is the Arizona Trust Company, and its principal place of business is Tuscon, Arizona. The income tax returns for each of the trusts for the years here involved were filed with the District Director of Internal Revenue, Phoenix, Arizona. Robert M. Heller and Joan E. Heller, husband and wife, have a mailing address of 55 Camino Espanol, Tuscon, Arizona. Their joint federal income tax return for 1957 was filed with the District Director of Internal Revenue, Phoenix, Arizona. (I-R. 90-91.)

Beginning in 1938, taxpayer entered into a partnership agreement with George Bromley and from 1938 to 1941 the partnership was in the house siding business in Detroit, Michigan, and Columbus, Ohio. In 1941 the partnership, known as American Homes Association, terminated its house siding business and engaged in the business of developing, building and selling real estate in the area of Columbus, Ohio. In the latter part of 1941 Bromley left the partnership and, thereafter, taxpayer operated the same business as an individual under the name American Homes Association until the business was terminated in 1944. (I-R. 91.)

In 1944, for reasons of his wife's health, taxpayer retired and moved to Beverly Hills, California. Thereafter he entered the photo-finishing business, which business was terminated in 1948, when he moved to Tucson, Arizona. In 1948 taxpayer formed a partnership with Bromley and with Jay Smotkin (taxpayer's brother) under the name of American Homes Association, hereinafter called the partnership. After Jay was bought out in 1949, taxpayer had a two-thirds interest and Bromley a one-third interest in the capital, profits and losses of the partnership. (I-R. 91.)

In February 1948 the partnership purchased an 80-acre tract of land near Tucson, Arizona, and by the latter part of 1949 or early 1950 the partnership had purchased two adjacent 80-acre tracts of land. During the period from 1948 to June 30, 1951, the partnership built and sold approximately 500 dwelling houses on two of the 80-acre tracts. (I-R. 92.)

During the period from July to November 1951, taxpayer and Bromley incorporated American Homes Association, American Building Company and six rental corporations (American Rentals, National Rentals, Federal Rentals, Joan Rentals, Harold Rentals and Carole Rentals). Taxpayer held a two-thirds interest and Bromley a one-third interest in both American Homes Association, hereinafter called American Homes, and American Building Company. In the last half of 1951 the National Realty Company, which held legal title to the third 80-acre tract for the benefit of taxpayer and Bromley, conveyed such legal title to the six rental corporations, whose stock was issued one-third to taxpayer, one-third to Bromley, and one-third to Bromley as trustee for taxpayer's children. In April 1952 the Arizona Trust Company became successor trustee in the trust created by taxpayer and wife for their children. (I-R. 92.)

During the years 1951 and 1952, 194 duplexes (388 dwelling units) were built on the third 80-acre tract by American Building Company for the six rental corporations. American Building Company was liquidated in January 1953. Prior to completion of the duplexes in July 1952, the six rental corporations applied for mortgage insurance from the Federal Housing Administration. In response to the question on the application form "Do you intend to occupy, rent, or sell this property?" the applicants answered "Rent", and in response to the second part of the same question, which asked for the "[p]roposed sale price (if for sale)", the applicants gave such sale price as $15,750 for each duplex. (I-R. 92-93.)

Construction financing for the 194 duplexes was obtained through banks and private individuals, and the loans were secured by the duplex lots, by othe real estate owned by taxpayer and Bromley and by the personal guarantees of taxpayer and Bromley. Permanent financing was obtained from bank and trust companies, an insurance company and a savings and loan association, and on some of these loans the personal guarantees of taxpayer and Bromley were required. (I-R. 93.)

The construction price charged by American Building Company to the rental corporations was $12,600 per duplex, which included coolers, venetian blinds, stoves and refrigerators. The $12,600 figure was also the sum of the permanent financing on each duplex. The land was reflected on the books of the rental corporations at $200 per duplex lot, making a total cost figure of $12,800 for each duplex. (I-R. 93.)

On January 2, 1952 a management agreement was executed by American Homes and the six rental corporations under which American Homes agreed to manage the 194 duplexes owned by the rental companies, to act as rental and operating agent and collect rentals, to advertise the properties for rental, and to maintain and repair the properties. It was agreed that American Homes would receive a commission of 10 percent of gross rentals during 1952 and 20 percent of gross rentals after January 1, 1953, and would pay all expenses in connection with the advertising, leasing, maintenance and repair of the properties. (I-R. 93.)

During 1953 the occupancy rate of the duplexes was about 65 percent, while during the years 1954 and 1955 the occupancy rate was about 72 percent. The financial statements of the rental corporations during the

period 1953 through 1955 show consistent losses. During the first three and one-half months the duplexes were rented, they were rented by written lease agreements. Thereafter, they were rented on an oral, month-to-month basis. (I-R. 94.)

In order to increase the tenant occupancy of the duplexes, taxpayer proposed early in 1954 that a swimming pool be constructed and that 120 of the units be furnished. Bromley was unwilling to make these changes, which would cost approximately $120,000, and on February 24, 1954 taxpayer and Bromley agreed to a division and distribution of their various property interests. Subsequently, the ownership in the six rental corporations and in American Homes was as follows: taxpayer, one-third; taxpayer's wife, one-third; and the Arizona Trust Company as trustee for taxpayer's three children, one-third. In 1954 American Homes constructed the swimming pool and purchased furniture for some of the rental units. (I-R. 94.)

During 1955 taxpayer obtained medical care and advice on numerous occasions for various ailments, including paroxysmal auricular tachycardia and a peptic ulcer of the duodenal. Taxpayer also suffered from general tension. Early in 1955 taxpayer was also treated by a cardiovascular specialist in San Francisco, California. Taxpayer was hospitalized in Tucson in the fall of 1955 for treatment of his peptic ulcer. Taxpayer had previously been treated by the cardiovascular specialist in San Francisco in 1952 and 1953. (I-R. 94-95.)

On September 1, 1955, the six rental corporations were liquidated and 186 duplexes were distributed to the stockholders in liquidation. The remaining eight duplexes had been sold between June 1 and August 31, 1955. American Homes served as selling agent for the stockholders and

proceeded as rapidly as possible to sell the duplexes. Taxpayer was president of American Homes during the years here in issue. Commencing on or about November 1, 1955, the duplexes were advertised for sale. Prior to that the duplexes were advertised only for rent. American Homes employed extensive newspaper and radio advertising as part of its selling efforts. About September 1955 American Homes moved its office to one of the duplexes, opened a model duplex for display, employed a staff of salesmen to handle the sales, and prepared and distributed sales brochures to customers. At the time of the sale of each duplex it was completely reconditioned and redecorated inside and out by American Homes. In addition, American Homes paid for the closing costs incurred in selling the duplexes. (I-R. 95.)

American Homes also offered the free use of the pool for a temporary period to a purchaser of a duplex and his tenant. The books and records of American Homes show that owners and tenants of the duplexes were not charged for pool service until May 1, 1958. A typical pool agreement stated that after a cut-off date the pool privilege would be optional to the owner and his tenants at a specified annual price. After the sale of duplexes and during the years in issue, American Homes acted as rental agent for some of the new owners. There was no charge for the rental service, but if American Homes collected the rents for the owners and disbursed the rents, a charge of $5 per month was made. The free rental service was to be provided for a five-year period. In addition, American Homes provided free garbage collection service for a limited period of time to owners of duplexes and their tenants. (I-R. 95-96.)

During the period 1955 to 1958, 169 duplexes were sold. The remaining 17 duplexes were exchanged in 1956 for a cattle ranch. Approximately 55 of the duplexes were sold furnished. Most of the duplexes were sold at prices ranging from about $15,000 to about $16,200. (I-R. 96.) A typical sale would be handled in the following manner (I-R. 96):

FHA mortgage assumed by purchaser	$11,419.98
Cash down payment	1,100.00
Contract	2,710.02
Total sales price	$15,230.00

The contract ($2,710.02 in the above example) executed by the purchaser provided for interest of 6 percent per annum and required payments of principal and interest totaling $25 per months, with the entire contract sum due in five years. If the sale involved a furnished duplex, then the contract would require a payment of principal and interest totaling $45 per month. (I-R. 96.)

Taxpayer generally paid American Homes $1,500 for each duplex sold through the period up to November 1956, and he paid $2,000 each for most of the duplexes sold after that date. (I-R. 96.)

During the years 1956 through 1962 the taxpayers also reported on their returns (I-R. 96) the following sales (I-R. 97):

Year	Asset Sold	Date Acquired	Gross Sales Price	Gain
1956	Land	1946 and 1951	$75,000.00	$67,967.19
1957	Land	Not shown	71,000.00	62,745.00
1958	Land	1948 and 1951	10,000.00	8,422.65
	Land	1955	4,021.42	2,258.58
	Land		8,571.43	4,898.34
1959	1/3 interest in ranch	1956 (acquired in exchange for duplexes)	58,942.58	35,263.60
	Land	Not shown	10,000.00	8,790.00
1960	Ranch	1956 (acquired in exchange for duplexes)	9,000.00	5,293.50
1961	Land	1959	28,000.00	25,691.14
1962	Car wash & land	1961	74,900.00	21,663.09
	Land & Bldg.	1956	44,008.94	40,957.27

In 1956 taxpayer obtained a real estate broker's license as a designated broker for American Homes. Such license has been renewed annually to the present time. Taxpayer is a member of the National Board of Realtors and the Tucson Real Estate Board. (I-R. 97.)

The taxpayers retained portions of each of three 80-acre tracts for commercial development. Subsequent to the sale of the duplexes, the commercial property was developed, with American Homes acting as contractor in building stores. The name of American Homes has now been changed to Greater Broadway Development Company. Taxpayer has recently been active in seeking a rezoning of certain land in the Tucson area to permit high rise structures. (I-R. 97.)

Taxpayers, on their respective federal income tax returns for the years here involved, reported the gains realized from the sale of the duplexes during that period as long-term capital gains. In addition, taxpayers (as cash basis taxpayers) considered the contracts received by them from the purchasers of the duplexes as having no ascertainable

fair market value and, accordingly, reported the payments on the contracts as income only in the year in which the payments exceeded their adjusted basis. (I-R. 98.)

The Tax Court found (I-R. 102) that the duplexes were being held primarily for sale to customers in the ordinary course of taxpayer's real estate business and that the gains realized during the taxable years were taxable as ordinary income.

The Tax Court also found (I-R. 104) that the contracts had a fair market value when received equal to 50 percent of their face value and were includable in taxpayers' taxable income at the fair market value in the year of sale.[3]

SUMMARY OF ARGUMENT

Taxpayer maintains that 186 duplexes which he sold or exchanged had been held for investment purposes. If true, then the profits would be entitled to be treated as long-term capital gains. If not, then the profits would be taxed as ordinary income.

Taxpayer contends that the duplexes had been acquired for rental purposes and had in fact been rented for three years prior to sale. However, the record supports an inference that even when the duplexes were originally acquired, taxpayer's primary purpose was sale. More important is that the original purpose, although important, is not controlling. Rather, it is the purpose for which taxpayer is holding the property during the taxable year which controls, and here there is no question that these duplexes were being held solely for sale.

3/ Another issue before the Tax Court was whether the Commissioner was correct in disallowing all amounts paid by taxpayers as selling commissions to American Homes in excess of 5 percent. (I-R. 97-98.) The Tax Court held (I-R. 106) that the total amounts paid by taxpayers

Taxpayer further urges that these properties were not sold in the course of his business because he was in the rental, not sales, business. Also, he submits that the sales merely constituted the liquidation of an investment. The flaw in such reasoning is that if a taxpayer's activities are similar to those usually engaged in selling realty, then he will be considered to have entered the real estate business. This is true whether or not taxpayer was in the real estate business before and it is immaterial what motivated him to enter the business, i.e., profit or liquidation. The record shows that taxpayer actively engaged in sales activity, employing radio, television, and newspaper advertising; had a model duplex on the premises, obtained a broker's license; and also gave brochures to customers. Thus it is quite apparent that during the taxable years, taxpayer was engaged in the business of selling realty.

The second issue deals with whether or not taxpayers received income in the years of sale. Taxpayers when selling the duplexes obtained from a purchaser a contract wherein the purchaser agreed to pay a specified sum at specified times. The Commissioner determined that these contracts had a fair market value of 50 percent of face value and that income, to that extent, was includable in taxpayers' income tax returns in the year of sale. Taxpayers, maintaining that these contracts had no fair market value, reported the proceeds from these contracts in the years payment were received. The Tax Court correctly--in our view--found that the contracts had a fair market value of 50 percent of face value.

Taxpayers urge that because they received no negotiable instruments with the contracts, the contracts had no fair market value. This is because without possession of a negotiable instrument, they had nothing

which was the equivalent of cash. Although the Tax Court--on whose decisions taxpayers rely--did at one time require that there be a negotiable instrument accompanying a contract before it would find a fair market value, that court has specifically rejected that view now. Therefore it is possible that a contract, standing alone, can have a fair market value. As for the obligations which taxpayers allege were attached to these contracts, thereby making them unmarketable, the record shows that these obligations were those of a corporation and not those of the taxpayers and, therefore, the obligations were in no way connected to the notes.

Both issues being ones of fact, they should be reversed only if clearly erroneous. Insofar as there is ample evidence to support both findings, they should be affirmed.

ARGUMENT

I

THE TAX COURT CORRECTLY HELD THAT DUPLEX HOUSES SOLD AND EXCHANGED BY TAXPAYER WERE NOT CAPITAL ASSETS BECAUSE THEY HAD BEEN HELD BY TAXPAYER PRIMARILY FOR SALE TO CUSTOMERS IN THE ORDINARY COURSE OF HIS TRADE OR BUSINESS

This is another in the long line of cases dealing with the question whether taxpayer held property for investment purposes or whether he held it primarily for sale to customers in the ordinary course of his trade or business. In the proceedings below, the Commissioner contended that taxpayer held 186 duplexes for sale to customers in the ordinary course of business, thereby not qualifying as capital assets (Section 1221(1) of the Internal Revenue Code of 1954,[4/] *supra*), which

4/ All references to sections are to the 1954 Code, unless otherwise

means that any gain realized on a sale or exchange would be subjected to tax as ordinary income. Taxpayer contended that the duplexes had been held for investment, thereby qualifying as capital assets, and, accordingly, that any gain on a sale or exchange would be entitled to preferential treatment where, as here, the property had been held in excess of six months. Section 1222(3), *supra*. The Tax Court, with all the evidence before it, concluded (I-R. 102) that taxpayer had held these duplexes primarily for sale to customers as part of his trade or business. This being a question of fact, the narrow issue on appeal is whether this finding was "clearly erroneous." *Rollingwood Corp.* v. *Commissioner*, 190 F. 2d 263, 265 (C.A. 9th); *Richards* v. *Commissioner*, 81 F. 2d 369, 370 (C.A. 9th); *Yara Engineering Corp.* v. *Commissioner*, 344 F. 2d 113 (C.A. 3d); *Broughton* v. *Commissioner*, 333 F. 2d 492 (C.A. 6th); *Coffey* v. *United States*, 333 F. 2d 945 (C.A. 10th); *Tidwell* v. *Commissioner*, 298 F. 2d 864 (C.A. 4th). If not, then, in accordance with the usual standards of review, it is entitled to finality. *Commissioner* v. *Duberstein*, 363 U.S. 278.

Despite all the litigation in this area, the facts remains that there "is no fixed formula or rule of thumb for determining whether property sold by the taxpayer was held by him primarily for sale to customers in the ordinary course of his trade or business and each case must, in the last analysis, rest upon its own facts." *Mauldin* v. *Commissioner*, 195 F. 2d 714, 716 (C.A. 10th). However, as a means of distinguishing between the dealer and the investor, the courts have developed certain guidelines, no one of which is determinative of the

issue. Frankenstein v. Commissioner, 272 F. 2d 135 (C.A. 7th), certiorari denied, 362 U.S. 918. As listed in Gault v. Commissioner, 332 F. 2d 94, 96 (C.A. 2d), these factors include:

(1) The frequency, number and continuity of the sales; (2) subdivision, platting, and other improvements or developments tending to make the property more marketable; (3) the extent to which the taxpayer engaged in sales activity; (4) the length of time the property has been held; (5) the substantiality of the income derived from the sales, and what percentage that is of the taxpayer's total income; (6) the nature of the taxpayer's business; (7) the taxpayer's purpose in acquiring and holding the property; (8) the extent of sales promotional activity, such as advertising; and (9) the listing of property for sale directly or through brokers. 5/

We submit that the Tax Court considered these factors and its finding and decision are correct.

Taxpayer's major contention (Br. 15-18) is that up to the time the properties were sold, his primary purpose was rental and not sale. While the original purpose is a matter of appropriate consideration by the Tax Court, it is not controlling. Rollingwood Corp. v. Commissioner, 190 F. 2d 263, 266 (C.A. 9th); Goldberg v. Commissioner, 223 F. 2d 709, 712 (C.A. 5th); Home Co. v. Commissioner, 212 F. 2d 637 (C.A. 10th);

5/ Cases wherein some or all of the above guidelines were utilized include: Palos Verdes Corp. v. United States, 201 F. 2d 256 (C.A. 9th); Tidwell v. Commissioner, supra; Patrick v. Commissioner, 275 F. 2d 437 (C.A. 7th); Gudgel v. Commissioner, 273 F. 2d 206 (C.A. 7th); Frankenstein v. Commissioner, supra; Mauldin v. Commissioner, supra; Goldberg v. Commissioner, 223 F. 2d 709 (C.A. 5th).

Friend v. Commissioner, 198 F. 2d 825, 288 (C.A. 10th); Dunlap v. Oldham Lumber Co., 178 F. 2d 781, 784 (C.A. 5th).[6/] If the original purpose were controlling, the statute would read "property purchased for sale" rather than "property held * * * for sale." Richards v. Commissioner, 81 F. 2d 369, 372-373 (C.A. 9th). Thus the courts have concluded that the ultimate question for decision, in determining whether property at the time of sale is held for investment or primarily for sale to customers, is the purpose for which taxpayer was holding the property at the time of the sale. Rollingwood Corp. v. Commissioner, supra; Galena Oaks Corp. v. Scofield, 218 F. 2d 217, 218 (C.A. 5th); Friend v. Commissioner, supra, p. 288; Mauldin v. Commissioner, 195 F. 2d 714, 717 (C.A. 10th); Harrah v. Commissioner, 30 T.C. 1236, 1241. However, because the original purpose should be considered and because taxpayer places great emphasis upon it, we shall discuss it; and we submit that there is sufficient evidence to support the Tax Court's finding (I-R. 100) that from the very beginning, taxpayer's primary purpose was sale.

To begin with, there is a complete absence of prior conduct by taxpayer indicating that he held property for rental or investment purposes. To the contrary, the record shows that taxpayer had been active in building, developing and selling real estate since about 1941 (in Columbus, Ohio) and later in 1948 in Tucson, Arizona. (I-R. 99.)

6/ Taxpayer cites (Br. 20) some cases for the proposition that the purpose at time of sale does not govern. These cases held that the trier of fact should not look solely to the intention at the time of sale but should also consider for what purposes taxpayer was holding the property prior to sale. In the case at bar, the Tax Court did consider taxpayer's intention from the time he acquired the land until

Indeed, the land on which the duplexes were built was one of three adjacent 80-acre tracts, all of which were acquired at approximately the same time. (I-R. 92.) On two of these tracts, taxpayer constructed and sold 500 dwelling units. (I-R. 92.) This occurred just prior to the construction of the duplexes. (I-R. 99.) While not conclusive, these facts do show that taxpayer was primarily engaged in building and selling homes and it was quite permissible to consider this aspect of taxpayer's activities.

Taxpayer submits (Br. 16-17) that while he may have built and sold homes previously, he had given up this activity and when he built the duplexes--they were built solely for rental purposes. Of course, a declared expression of intention is not binding upon either the Commission or the courts. Noble v. Commissioner, 368 F. 2d 439, 443 (C.A. 9th). Moreover, there is evidence indicating that renting was not taxpayer's sol intention when he built the duplexes.

Prior to the completion of the duplexes, the six rental corporations applied for mortgage insurance from the Federal Housing Administration (FHA). (I-R. 92.) On the application form, there was a question consisti of two parts (Ex. 56DDD, Question 6):

> Do you intend to occupy, rent or sell this property?
> Proposed sale price (if for sale).

To the first part, taxpayer responded "Rent." The second part was of relevance only to those who had expressed an intent to sell. Nonetheless, taxpayer put down a sales price of $15,750. As the Tax Court noted (I-R. 99-100) this "* * * figure coincides remarkably with the price range of duplexes when they were actually sold." True, such evidence, standing

(Br. 18) that he did not originally intend a sale of these units.

Furthermore, the fact that the houses were rented on oral leases on a month-to-month basis supports the inference which might well be taken that taxpayer wished to keep the duplexes easily available from the very beginning.

Finally, taxpayer's purported reasons for switching from rental to sale are not borne out by the evidence. Thus he claims (Br. 17) that ill health and the deterioration of the rental market in 1955 forced him to sell. Yet his ill health, as the Tax Court noted (I-R. 100), had existed as early as 1952 and 1953, and there is nothing in the record to indicate that his health was any worse in 1955 than in 1952. In fact, taxpayer's health could not have been of such a nature to force him to sell for he not only supervised the repairing of the duplexes (II-R. 50)[7] but he has continued as an executive of American Homes since the sale of the duplexes (I-R. 101). In short, taxpayer's health could not have caused any change in his plans, and the inference remains that in 1955 he was simply implementing his primary purpose--sale of the duplexes.

Nor can much weight be given to taxpayer's claim that the lack of a rental market in 1955 caused him to sell. As the Tax Court pointed out (I-R. 100), taxpayer's own testimony was that the rental market had collapsed by the middle of 1952. If so, then losses could have and should have been anticipated. Yet, within one year of completion of the duplexes, taxpayer had consulted with an appraiser as to what price could be obtained

7/ "II-R." references are to Volume II of the record on appeal, which contains the transcript of proceedings in the Tax Court.

if some of the duplexes were sold. (II-R. 68-71, Ex. XXX.) If the rental market was depressed in 1952 and therefore losses could have been anticipated, taxpayer's willingness to consider sale so quickly again indicates that he was not primarily holding the units for rent.

Moreover, taxpayer claimed that due to factories closing, there was a poor employment picture, which meant there was little demand for rental units for workers. While this may have been true in 1952, it was not the situation in 1955. (I-R. 100.) In fact, after 1952, the general employmen situation was on the upswing in the Tucson area. (II-R. 73, 74; Ex. 80-ZZZ Thus it is apparent that neither health nor economic conditions in 1955 could have been the reason for taxpayer to give up his purported primary purpose. 8/

As we noted previously, taxpayer's purpose in acquiring the property, or even his purpose in holding the property prior to sale, is not controlli Rather, it is his purpose at the time of sale, i.e., his purpose in holding the property during the taxable years. Here, of course, there is no questi that from late 1955 to 1958, taxpayer's chief--indeed, sole--purpose was sale of the duplexes. Thus the only question remaining is whether these properties were sold in the ordinary course of taxpayer's trade or business.

8/ Taxpayer claims (Br. 15) that the Tax Court misinterpreted and misapplied the Supreme Court's directive as set forth in Malat v. Riddell, 383 U.S. 569. In that case, taxpayer had a "dual purpose" in acquiring the property, i.e., to develop it for rental purposes or to sell it. The Supreme Court, resolving a conflict in the appellate courts as to whether a "primary" purpose meant "substantial" or "first in order of importance," decided upon the latter. It then remanded the case to the District Court in order that taxpayer's primary purpose might be ascertained. Here, of course, the Tax Court noted (I-R. 101) taxpayer did have a rental purpose in mind when acquiring the property, but that the purpose of first importance was sale. As our brief shows, there is sufficient evidence to support this finding.

In other words, was taxpayer engaged in the business of selling dwelling units during the taxable years?

Although taxpayer refers to the sale of the duplexes as a liquidation (Br. 16, 17), it is well established that the fact that property is sold for purposes of liquidation does not foreclose the determination that a trade or business is being conducted by the seller. Ehrman v. Commissioner, 120 F. 2d 607, 610 (C.A. 9th), certiorari denied, 314 U.S. 668; Commissioner v. Boeing, 106 F. 2d 305, 309 (C.A. 9th), certiorari denied, 308 U.S. 619; Richards v. Commissioner, supra; Home Co. v. Commissioner, supra; White v. Commissioner, 172 F. 2d 629, 630-631 (C.A. 5th). As stated by this Court in Ehrman v. Commissioner, supra (p. 610)--

> We fail to see that the reasons behind a person's entering into a business--whether it is to make money or whether it is to liquidate--should be determinative of the question of whether or not the gains resulting from sales are ordinary gains or capital gains. The sole question is--were the taxpayers in the business of subdividing real estate?

Or, as said in Home Co. v. Commissioner, supra (p. 641)--

> One may, of course, liquidate a capital asset. To do so it is necessary to sell. The sale may be conducted in the most advantageous manner to the seller and he will not lose the benefits of the capital gain provision of the statute, unless he enters the real estate business and carries on the sale in the manner in which such a business is ordinarily conducted. In that event, the liquidation constitutes a business and a sale in the ordinary course of such a business and the preferred tax status is lost.

What, then, do the courts look to in order to determine whether a taxpayer's activities were such as to constitute the carrying on of a real estate business?

Essentially the courts look to the general "busyness" of the taxpayer, and this is measured by the frequency and continuity of sales, the extent of advertising, whether real estate agents were employed, and whether purchasers were actively solicited. Commissioner v. Boeing, supra, p. 309; Goldberg v. Commissioner, supra, p. 712; Home Co. v. Commissioner, supra, p. 641. Where these are minimal, then taxpayer's activities are not such as to amount to the everyday operation of a business. But in the case at bar, it is clear that taxpayer's activities clearly constituted the operatio of a business.

Taxpayer began selling the duplexes in November 1955. (Ex. 60-HHH(1).) Approximately two months later (January 1956), he applied for and obtained a real estate broker's license as a designated broker for American Homes. (Ex. 63-KKK.) The advertising was extensive, employing newspaper, televisio and radio. (Ex. 60-HHH(1) & (2); Ex. 61-III.) Sales brochures were distributed to customers. (I-R. 100; Ex. WWW.) A model duplex was opened for display purposes and all the units were reconditioned and redecorated, inside and out. (I-R. 100.) A total of 169 duplexes were sold from 1955 to 1958, with most of the prices raning from $15,000 to $16,200. (I-R. 101.) Nor did these sales mark the end of taxpayer's real estate activities, for, as the Tax Court noted (I-R. 101), taxpayer continued in the real estate business in subsequent years.

The above facts amply demonstrate that no matter what business taxpayer was in before or after the taxable years, he was clearly in the business of selling realty from 1955 to 1958. To contend otherwise, as does taxpayer (Br. 17-18), is a contention completely without merit.

Finally, there is no dispute here on the proposition that a taxpayer engaged in some phase of the real estate business may take advantage of real estate investment opportunities and receive preferential long-term capital gain treatment on profit from their subsequent sale. It is a question of fact in each case as to whether a taxpayer's "investment" activities are so different from those of a taxpayer who sells realty so as to require that the two be treated differently. The taxpayer seeking the preferential treatment has the burden of establishing the line of demarcation in order to prevail. As the record clearly demonstrates, this taxpayer did not carry that burden.

II

THE TAX COURT WAS CLEARLY CORRECT IN HOLDING THAT THE DEFERRED PAYMENT CONTRACTS EXECUTED BY PURCHASERS OF DUPLEXES HAD A FAIR MARKET VALUE OF 50 PERCENT OF FACE VALUE AND TO THAT EXTENT, WERE INCLUDABLE IN TAXPAYERS' INCOME IN THE YEAR OF SALE

Section 1001(a), supra, provides that "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis * * *." Section 1001(b), supra, defines "amount realized" as being "the sum of any money received plus the fair market value of the property (other than money) received." A cash basis taxpayer, such as those here, would include his gain in the year received. Section 451, supra. In the instant case, when taxpayers sold a duplex they generally received from the buyer: (1) cash down payment and (2) a deferred payment contract providing for monthly payments with the entire contract sum due in five years. (I-R. 96.) It is taxpayers' contention here (Br. 23-25), as it was below, that these contracts had no ascertainable

fair market value and thus were income only in the year payments were actually received. On the other hand, the Commissioner determined that the contracts had a fair market value of 50 percent of their face value and, therefore, were includable (to that extent) in taxpayers' income in the year of sale. On the bais of the entire record, the Tax Court found (I-R. 104) they had "a **fair** market value when received equal to 50 percent of their face value and that they are includable in petitioners' taxable income at that fair market value in the year of sale." Fair market value is a question of fact. In re Williams' Estate, 256 F. 2d 217, 220 (C.A. 9th); Penn v. Commissioner, 219 F. 2d 18, 20 (C.A. 9th); Marsack's Estate v. Commissioner, 288 F. 2d 533, 535 (C.A. 7th) Therefore, unless clearly erroneous, this finding may not be reversed on appeal. Commissioner v. Duberstein, supra.

The major thrust of taxpayers' contention (Br. 24-25) is that these contracts could not have had an ascertainable fair market value because they, taxpayers, received no negotiable instruments, i.e., nothing that could be considered the equivalent of cash. While it is true that some courts have made a distinction between taxpayers who received negotiable instruments (note or mortgage) and those who did not and, in turn, concluded that the former had an amount realized, while the latter did not have an amount realized, this Court in Phillips v. Frank, 295 F. 2d 629, 633, termed the distinction "illusory." Equally true is that the Tax Court, upon whose cases taxpayers rely, has renounced its former reliance upon such a distinction. Estate of Ennis v. Commissioner, 23 T.C. 799, non-acquiescence, 1956-2 Cum. Bull. 10. See especially

Perelman v. *Commissioner*, 41 T.C. 234, 242, fn. 11, acquiescence, 1956-2 Cum. Bull. 6. See also *Darby Investment Corp.* v. *Commissioner*, 315 F. 2d 551 (C.A. 6th). In short, a contract may have a fair market value even if it is not a negotiable instrument. *Cowden* v. *Commissioner*, 289 F. 2d 20, 24 (C.A. 5th). Therefore, the question is not whether these contracts were negotiable, but whether they had a fair market value when received. The Tax Court concluded that they did have a value and, we submit, there is evidence to support such conclusion.

It is true, as taxpayers note (Br. 25-26), that Klafter did testify that these contracts had no market value, but this was only after he had concluded that the contracts were not negotiable (II-R. 59). Of course, the negotiability of the contracts has little bearing on the question, as we have already discussed. Later, Klafter testified that there would have been no market for these contracts because he assumed that certain conditions were attached to them. (II-R. 65.) But when asked whether *without* these purported conditions the contracts would be marketable, that is, would an expert such as he buy them, Klafter stated that he would. (II-R. 66.) Thus the question exists: Did these contracts have the conditions attached to them as Klafter assumed? As the Tax Court found (I-R. 103), none of these conditions--free pool service, garbage collection, and rental service--attached to these contracts.

Taxpayers contend (Br. 27) that because American Homes Association was their selling agent, then the contracts it made pertaining to the pool, rental, and garbage services were binding on them under principles of agency law. The flaw in taxpayer's anaylsis is that they fail to

appreciate that American Homes was a corporation and, during the taxable years, was engaged in a dual capacity: It acted as an agent and as a principal. Thus there is no dispute that American Homes was solely an agent insofar as the selling of the duplexes was concerned. (I-R. 95.) As the Contract for Sale of Real Estate (Ex. 6-NNN) makes clear, it was the taxpayers who were the sellers, not American Homes. True, if the corporation did make representations regarding the duplexes, such representations may have bound taxpayers because the corporation was their agent. But it does not follow that the contracts entered into by American Homes on its own behalf and pertaining to its own properties or services could in any way bind the taxpayers.

The pool was owned by American Homes and operated by it. (I-R. 94.) It appears that it also arranged for the garbage service. 9/ Obviously, if it then entered into an agreement pertaining to these items, it was acting solely on its own behalf, i.e., as a principal. The contracts regarding these services were entered into by American Homes and a purchaser or tenant. None of the service contracts make reference to the deferred payment contracts, and vice versa. If there was a breach of a condition--for example, if American Homes attempted to charge for the pool prior to the time it had agreed upon--the contracting party could look to the corporation for damages, and to the corporation alone. Thus it is quite evident that these obligations to provide service were separate and distinct from the realty contracts.

9/ The garbage pick-up was to be handled by the Arizona Transport Agency. (Ex. 73-UUU(1).) The record does not indicate whether this was a private corporation or a municipal agency. In any event, it is clear that the taxpayers individually were not obligated to operate

As the Tax Court stated (I-R. 103), " * * * these were obligations of American Homes, a separate corporation, and not petitioners' obligations * * *". Clearly, then, Klafter was mistaken when he thought that these conditions were attached to the contracts and, therefore, any conclusion that the contracts had no fair market value--because of the conditions--would be in error.

As to the amount of the discount, Klafter testified (II-R. 67) that it would range from 40 percent to 65 or 70 percent, depending on such factors as the amount of the purchaser's equity, the earnings power of the purchaser, whether he had paid a fair price, and the purchaser's over-all financial responsibility. As to these factors, the Tax Court noted (I-R. 103):

> The record shows that such factors would be favorable, since the duplexes had all been completely reconditioned, the sales prices were not much in excess of a sales price suggested by an appraiser in 1953, the purchasers generally made cash down payments of at least 10 percent of the purchase price and in many cases even higher down payments, a purchaser could rent one-half of his duplex to a tenant, and finally, there is no indication that the payments on these contracts (which had to be paid in full within a five-year period) were not generally made as required.

We need but note that the Commissioner's 50 percent discount is within the range at which Klafter would have discounted these contracts.

It is axiomatic that the Commissioner's determination of fair market value is prima facie correct, and the burden is on the taxpayer to prove that it was erroneous. Fleming v. Commissioner, 153 F. 2d 361, 363 (C.A. 5th), and cases cited therein. As the record amply demonstrates, these taxpayers did not carry their burden.

CONCLUSION

For the reasons stated above, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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FEBRUARY, 1967.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated:________________day of________________, 1967.

____
Attorney

No. 21,185

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

JOAN E. HELLER TRUST, et al.,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

R spondent

ON PETITION FOR REVIEW OF THE DECISION OF THE

TAX COURT OF THE UNITED STATES

REPLY BRIEF FOR THE PETITIONERS

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INDEX

CITATIONS

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Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

REPLY BRIEF FOR THE PETITIONERS

ARGUMENT I.

The Government makes several contentions regarding the issue of taxpayers' liquidation of the duplexes resulting in ordinary income rather than capital gains.

The first argument is that this is a question of fact, and that the only issue on review is whether or not the decision of the Tax Court was "clearly erroneous". (B.15).

We agree that this issue involves a question of fact. We believe the rule is that this Court may reverse if the Tax Court's decision is "clearly erroneous", or if it is clear on the record as a whole, that a mistake has been made. Austin v. Commissioner, 263 F.2d 460 (C.A. 9).

We submit that the uncontradicted evidence set forth on pages 16 and 17 of our Opening Brief is more than sufficient to meet either of these review tests. Conversely, there are no decision or determinative facts to support the Tax Court's conclusion that from the beginning these dwelling units were held by the taxpayers for the primary purpose of sale. (R.100) There are only two alleged circumstances which would in any way support the Tax Court's findings: the FHA Application (Petitioners' Brief, Appendix 1), which is most inconclusive, and the fact that from 1948 to 1951 taxpayer Smotkin built houses for sale. Under the Government's argument, the taxpayer is apparently condemned forever to ordinary income treatment, because

four years prior to the sales in question he sold houses, even though the undisputed evidence was that taxpayers had no bought or sold one house (other than the duplexes in question) from 1951 to the present time. (Trans.30) The Government even reaches further. It claims that the fact that taxpayer Smotkin built and sold houses in Columbus, Ohio, in 1941, indicates that he must not have held the duplexes built in 1952 for rental or investment purposes. (B.17) This argument is made on the fact of evidence disclosing that taxpayer Smotkin shortly after 1941 left Ohio, and for several years was in the photo-finishing business in California. (R.91) We submit that where an investment and rental program has been followed through for a period of three years, "it is there for all to see", (Malat v. Riddell, 347 F.2d 23, 26 (C.A. 9), and in the absence of convincing evidence to the contrary, the Tax Court's opposite conclusion was "clearly erroneous" and must leave this Court with clear impression that a mistake has

four years prior to the sales in question he sold houses, even though the undisputed evidence was that taxpayers had no bought or sold one house (other than the duplexes in question) from 1951 to the present time. (Trans.30) The Government even reaches further. It claims that the fact that taxpayer Smotkin built and sold houses in Columbus, Ohio, in 1941, indicates that he must not have held the duplexes built in 1952 for rental or investment purposes. (B.17) This argument is made on the fact of evidence disclosing that taxpayer Smotkin shortly after 1941 left Ohio, and for several years was in the photo-finishing business in California. (R.91) We submit that where an investment and rental program has been followed through for a period of three years, "it is there for all to see", (Malat v. Riddell, 347 F.2d 23, 26 (C.A. 9), and in the absence of convincing evidence to the contrary, the Tax Court's opposite conclusion was "clearly erroneous" and must leave this Court with clear impression that a mistake has

been made. If taxpayer was holding these duplexes primarily for sale during the three-year rental period, he will surely go down in history as the world's worst salesman. He was not able, in this three-year period, to sell one of 194 duplexes!

If taxpayer, from the beginning, primarily intended to sell, rather than rent, he must have been very confused in his thinking, for there would have been no need for him to go to the expense and trouble of creating and operating six rental corporations and a management corporation. (R.88-d).

The Government contends that the purpose for which taxpayer is holding the property at the time of the sale is controlling. (B.12,20). This is not the law, and it is submitted that it could not be the law. If we just look at the time taxpayer is selling, then no one would be entitled to capital gain treatment, and the Statute would be nullified. Municipal Bond Corp. v. Commissioner, 341 F.2d 683, 689

(C.A. 8); Philber Equipment Corporation v. Commissioner, 237 F.2d 129 (C.A. 3). In the latter case, the Tax Court had held that even if there was no intention to sell at the time of original acquisition, the determining factor was the purpose for which the property was being held at the time of sale rather than the purpose for which it was originally acquired and held. The Third Circuit in reversing stated, (237 F.2d 129 at 132-133):

> "We cannot subscribe to this 'alternative ground'. To do so would make for judicial nullification of Section 117(j).
>
> The essence of the Tax Court's alternative ground is that property changes character merely by the fact of being exposed for sale. We agree with taxpayer that such a concept is neither logical nor reasonable."

In McGah v. Commissioner, 193 F.2d 662 (C.A. 9), this Court recognized that same rule. The Tax Court had held that houses were being held at the time of the sale, primarily for sale to customers in the ordinary course of a trade or business. This Court remanded for findings as to how the houses were held prior

to the time of sale.

The Tax Court in another post Malat decision attempted to use the reasoning of the Government and the Tax Court here. In William A. Scheuber v. Commissioner, 25 T.C.M. 559 at p.564 (1966 CCH - TCM 1966-107) the Court stated:

> "It is the principal or primary purpose at the time of the sale that is significant [citing cases]. Even if we were to conclude that the property in question was originally acquired by petitioners as an investment, that purpose is necessarily subject to change. The original purpose then is replaced by a subsequent one, if any, and we must determine the purpose of first importance at the time of sale. Bauschard v. Commissioner, supra; Mauldin v. Commissioner, 195 F.2d 714 (C.A. 10) (1952) affirming 16 T.C. 698 (1951)."

The Seventh Circuit just recently reversed this case and its findings as being clearly erroneous. Scheuber v. Commissioner, 370 F.2d   , decided February 2, 1967 (1967-1 USTC 9219).

We note that the Government dismisses the latest Supreme Court case on the capital gains issue with a footnote (B.20). We further note that the Government fails to distinguish

or cite _Municipal Bond Corp._ v. _Commissioner_, 46 T.C. 219 (on remand from the Eighth Circuit 341 F.2d 683, and pursuant to _Malat_). The Government has failed to answer the arguments on _Malat_ set forth in our Opening Brief (B.15-20). Respondent attempts to dismiss _Malat_ by saying (B.20, FN 8):

> "* * * Here, of course, the Tax Court noted (T-R.101) taxpayer did have a rental purpose in mind when acquiring the property, but that the purpose of first importance was sale. As our brief shows, there is sufficient evidence to support this finding."

We submit that the Tax Court never made a finding that taxpayer at acquisition had in mind as of first importance, the sale of the property (Petitioner's Brief 19). We further submit that Respondent's brief does not show evidence to support any such finding.

ARGUMENT II.

For the reasons stated in our Opening Brief, we believe the contracts in question had no ascertainable fair market value.

CONCLUSION

The decisions of the Tax Court are erroneous and should be reversed.

Respectfully submitted,

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I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those Rules.

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No. 21,194

United States Court of Appeals

For the Ninth Circuit

CARL S. ZILK and FLOMATIC SALES CORPORATION, an Oregon corporation,

Appellants,

vs.

DEATON FOUNTAIN SERVICE, a partnership comprised of William F. Deaton and C. J. DeCeasare,

Appellee.

APPELLANTS' OPENING BRIEF

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Subject Index

Table of Authorities

Cases

Pages

Other Authorities

No. 21,194

United States Court of Appeals

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CARL S. ZILK and FLOMATIC SALES CORPORATION, an Oregon corporation, *Appellants,* vs. DEATON FOUNTAIN SERVICE, a partnership comprised of William F. Deaton and C. J. DeCeasare, *Appellee.*	}

APPELLANTS' OPENING BRIEF

This is an appeal from an order of the District Court granting the motion of defendant Deaton (appellee) for judgment notwithstanding the jury verdict returned in favor of plaintiffs (appellants).

JURISDICTION

Jurisdiction of the District Court is based upon U.S. Code, Title 28, Section 1338(a). The complaint alleges a claim for patent infringement arising under the Acts of Congress relating to patents (CT. 1). The answer admits the jurisdictional facts (CT. 31, 118).

Jurisdiction of this Court is based on U.S. Code, Title 28, Section 1291. The order of the District Court granting Deaton's motion for judgment notwithstanding the verdict is a final decision on the claim for relief which is pleaded in the complaint. That order entered judgment for Deaton on May 12, 1966 (CT. 266). Appellants filed their notice of appeal on June 3, 1966 (CT. 270), within the thirty day period provided by U.S. Code, Title 28, Section 2107.

STATEMENT OF THE CASE

Zilk patent No. 2,887,250 for a bar mix dispenser (PX 1) was granted to plaintiff Carl S. Zilk on May 19, 1959 and ever since has been exclusively licensed to plaintiff Flomatic Sales Corporation (PX 2). In the District Court plaintiffs charged defendant Deaton Fountain Service and the United California Bank with infringement of the Zilk patent (CT. 1-3). Plaintiffs sought damages on account of the alleged infringement and demanded a trial by jury (CT. 3).

The action was dismissed as to United California Bank on March 4, 1963 and no appeal was or is now taken from that dismissal (CT. 274). In its answer Deaton denied infringement and alleged invalidity of the patent on several grounds (CT. 31-37, 118-124). A counterclaim in which Deaton sought damages from plaintiffs (CT. 38-9, 124-5) was dismissed by stipulation during trial on February 8, 1966 (CT. 185h).

Evidence was received on all issues during a four day jury trial (RT. 1-340). Following presentation of plaintiffs' prima facie case to the jury, defendant Deaton

moved the District Court to direct a jury verdict in its favor on the ground that patent 2,887,250 was invalid (RT. 167-189). The District Court denied the motion for directed verdict (CT. 257). After presentation of all of the evidence and following appropriate jury instructions on the issues of patent validity, infringement and damages (RT. 300-339), the District Court submitted the case to the jury (RT. 339). The jury under Rule 49(b) of the Federal Rules of Civil Procedure answered written interrogatories on the issues of validity and infringement for each of the eight patent claims (CT. 185b-185g) and returned a general verdict for damages in favor of plaintiffs (RT. 344-346, CT. 185a).

Defendant Deaton then moved for judgment in its favor notwithstanding the jury verdict (RT. 346; CT. 186-187) again on the ground that patent claims were invalid. The District Court granted the motion for judgment n.o.v., set forth in a written opinion its reasons for doing so, and entered judgment for defendant Deaton (CT. 257-269). Plaintiffs then appealed to this Court (CT. 270).

Factual background and issues

The Zilk patent relates to a push-button dispenser for bar mixes (PX 1). In its order granting judgment n.o.v. the District Court found that the patented dispenser "is basically an apparatus for dispensing a plurality of bar mixes including soda and flavored soft drinks such as 7-up, Coca Cola, etc. The patented construction includes a dispensing head attached to one end of a flexible hose. Finger operated electrical push buttons on the head actuate bar mounted valve means to supply any one of several bar mixes to the head. By depressing a push

button on the head an operator can with one hand dispense one or several bar mixes from a nozzle in the head into a drink glass" (CT. 258-259). The main objective of the device is the one-handed dispensing of several bar mixes (PX 1, Col. 1, lines 28-31).

The patent issued with eight claims, all of which are in suit (PX 1). Claim 1 is typical. It claims a combination of mechanical elements, which element by element are (PX 7):

> 1. A dispensing apparatus comprising
>
> a dispensing head having a nozzle,
>
> a handle for said head,
>
> a remotely located valve means to selectively regulate the supply of a plurality of fluids to said head,
>
> a plurality of flexible conduits extending from said valve means to said head and communicating with said nozzle to deliver said plurality of fluids to said nozzle,
>
> electric power means for said valve means for operating said valve means to selectively supply said fluids to said head,
>
> switch means carried by said handle to control the supply of electrical energy to said power means,
>
> flexible electrical conductors extending from said power means to said switch means to enable said control,
>
> means holding said conduits and flexible conductors together in contiguous relationship to provide a single flexible member enabling said head to be moved freely relative to said valve means,

said handle having a shape fitting in one hand of the operator with the nozzle located adjacent such hand,

said switch means including a plurality of independently operable push buttons, each push button being operable when actuated to control operation of the valve means to cause a supply of at least one selected fluid to said nozzle through said conduits,

said push buttons being grouped on said handle to provide for operation of any push button by the thumb or a finger of said one hand of the operator without changing the grip of such one hand on the handle thus freeing the other hand of the operator for other uses while permitting the selective discharge of a plurality of fluids from said nozzle.

The evidence showed that plaintiff Zilk conceived the patented dispenser on July 19, 1957 (RT. 43-44) and subsequently manufactured and leased or sold dispensers to bars and restaurants initially in Oregon (PX 3A, PX 3B, PX 9A, PX 9B; RT. 9-12, 87-99). Thereafter, numerous competitors also began to manufacture and market practically identical dispensers (PX 4, PX 5, PX 6; RT. 117, 152-155).

Defendant Deaton since May 19, 1959 sold and leased dispensers made by three different manufacturers called the Barmaster dispenser (PX 4), the Carbonic dispenser (PX 5), and the McCann dispenser (PX 6). The jury in answer to written interrogatories 17, 18, 19, 20, 21 and 22 found as ultimate facts that each of these three dispensers infringed all eight patent claims (CT. 185e-185g). The District Court did not disturb these findings. Infringement, therefore, is not an issue on this appeal.

The jury also found each of the eight Zilk patent claims to be valid and made specific fact findings with respect to the two statutory bases for patentability which were in issue, U.S. Code, Title 35, Sections 102 and 103, which deal with novelty and obviousness, respectively.

The jury first found as an ultimate fact that there was not anywhere disclosed in the prior art on July 19, 1957, the combination of elements recited in the patent claims (CT. 185b-185e; Interrogatories 1, 3, 5, 7, 9, 11, 13 and 15). The District Court also did not disturb this finding and, as a consequence, the novelty of the patented dispenser under U.S. Code, Title 35, Section 102 is not an issue here.

The District Court did, however, disagree with the jury findings of ultimate fact which paraphrased Section 103 (CT. 260-65). The jury had found for each patent claim that the improvement or advance made by patentee Zilk in his combination of elements would not have been obvious to one of ordinary skill in the dispenser art on July 19, 1957 (CT. 185b-185e; Interrogatories 2, 4, 6, 8, 10, 12, 14 and 16). The lower court set aside these findings and the verdict for plaintiffs, as well. This appeal, therefore, focuses upon the issue of obviousness under U.S. Code, Title 35, Section 103.

The jury finding of nonobviousness followed presentation to it of evidence relevant to the scope and content of the prior art and of evidence showing the level of ordinary skill in the dispenser art. This evidence included the testimony of plaintiff Zilk concerning his early work in the dispenser field (RT. 46-49, 59-61) and concerning the early devices of others (RT. 44-48, 50-57, 58-59, 64-78);

prior art bar mix dispensers which were on the market before July 19, 1957, including the "Wheco" or "Speedbar" dispenser (DX B), the Carbonic lever valve (DX C), and the Barmaster "Magic Wand" (DX D, DX E, DX F); the three patents cited by the Patent Office during prosecution of the Zilk patent application (DX L, DX M, DX N); an earlier Zilk patent 2,820,675 for a soda dispenser (DX A); and thirteen other prior art dispenser patents which were not cited by the Patent Office (DX O-1 through O-13). The jury also heard plaintiff Zilk describe his conception of the patented dispenser on July 19, 1957 (RT. 43-44, 78-86) and describe how it differed from prior art dispensers on the market at that time (RT. 106-126).

Of particular importance here, the jury also had before it affirmative evidence (PX 12, DX G; RT. 132-135) that the patented dispenser was not obvious to those as skilled in the dispenser art as Barmaster, the manufacturer both of a later infringing dispenser (PX 4) and of the prior art "Magic Wand" (DX D, DX E, DX F) which the District Court considered "foremost of the prior art devices" (CT. 261). Faced with the problem of providing a dispenser for several bar mixes for a one-armed bartender, Barmaster had used foot operated treadle switches (DX G), not the one-handed solution to the same problem which is found in the patented combination.

The jury was instructed on the issue of obviousness in the precise terms of U.S. Code, Title 35, Section 103 (RT. 322):

> "The patent statutes passed by the United States Congress define the basic test of patentable invention as follows:

> a patent may not be obtained though the invention is not identically disclosed or described in the prior art, if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having the ordinary skill in the art to which said subject matter pertains.
>
> The patentability of an invention is in no way negatived by the manner in which the invention was made.''

The trial court further amplified the code language as follows (RT. 322-324):

> ''It is possible to obtain a valid patent claim defining a combination of old elements, if the old elements are assembled, or combined, in a way not shown in the 'prior art' or in such a way as to produce a new or advanced or improved result. That is to say, the combination, or assembly, of old elements is patentable if it is itself 'new' or produces in some way or manner, a result which would not have been expected by a person having ordinary skill in the dispenser art.
>
> As applied to this case, the test is whether the combination, or assembly of mostly old elements in a dispenser was a new combination of those old elements, and one which would not have been obvious to a person having ordinary skill in the art, who set about to design and build an improved dispenser at the time of the claimed invention.
>
> Invention is the double mental act of discerning some deficiency or need and pointing out or finding the means of overcoming it.

> The fact that the combination of elements is simple or the individual elements of the combination may be easily obtained on the open market or easily assembled does not negative the patentability of the claimed combination.
>
> * * *
>
> If you find that the differences between the claimed Zilk invention and the 'Wheco' or 'Magic Wand' devices are such that the claimed Zilk invention, as a whole would have been obvious in July of 1957, to a person of ordinary skill in the bar dispensing art, you shall hold the Zilk patent invalid and return a verdict for the defendants."

In considering Deaton's motion for judgment n.o.v. the District Court reexamined the jury finding that the Zilk combination would not have been obvious, concluded that it was obvious, and entered judgment for defendant Deaton (CT. 257-269). The lower court acknowledged that "the issue of obviousness or nonobviousness is basically a question of fact * * * which the jury in this case determined in favor of the plaintiff on all eight claims", but continued "a full review of the scope and content of the prior art on the claims at issue, and the level of ordinary skill in the art, lead this Court to the inescapable conclusion that no reasonable jury could have concluded that the Zilk invention was nonobvious to one skilled in the bar dispensing art in July, 1957" (CT. 260).

The District Court further set aside the jury verdict for the stated reason that "the Zilk invention fails to meet the general level of innovation necessary to sustain patentability" (CT. 259). The requisite "general level

of innovation'' is that very condition of nonobviousness which Congress codified in Section 103.

Question presented

This appeal, therefore, presents a single issue. Did the District Court deny to appellants their right of trial by jury as a consequence of its reexamination of the issue of obviousness which had been tried by the jury under appropriate instructions from the Court?

Appellants submit that this question should be answered in the affirmative. All of the following specifications of error relate to this single issue.

SPECIFICATION OF ERRORS

In accord with Rule 18(d) of this Court, appellants specify that the District Court erred:

1. By denying to plaintiffs their right to trial by jury which was preserved by Amendment VII of the Constitution of the United States.

2. By reexamining, otherwise than according to the rules of common law, issues of fact which had been tried by jury under appropriate instructions by the Court.

3. In granting defendant's motion for judgment notwithstanding the jury verdict and in entering judgment for defendant Deaton (CT. 266).

4. In concluding that the patent in suit is invalid as a matter of law, that the jury verdict must be set aside, and that judgment must be entered for defendant (CT. 258).

5. In concluding that "no reasonable jury could have concluded that the Zilk invention was nonobvious to one skilled in the bar dispensing art in July, 1957" (CT. 260).

6. In concluding that "the jury findings on Section 103 issues must be set aside and resolved in favor of defendant" (CT. 260).

7. In concluding that "even if the ordinary skill possessed by persons engaged in the bar-dispensing field were postulated at the minimum conceivable level, Zilk's dispensing device would clearly have suggested itself as a possible solution to a person possessing such skill who was given the 'Wheco' and 'Magic Wand' device and told to alter it in such a way as to provide for one-handed dispensing of a plurality of fluids" (CT. 264).

8. In concluding that "the jury was unreasonable in finding that the Zilk patent was nonobvious" (CT. 265).

9. In concluding that as a matter of law the Zilk patent "does not meet the statutory mandates established by 35 U.S.C. Sec. 103" (CT. 265).

10. In concluding that as a matter of law "the Zilk invention fails to meet the general level of innovation necessary to sustain patentability" (CT. 259).

11. In concluding that the evidence failed to show that the Zilk concept met "the A. & P. Tea Co. standard of invention" (CT. 265).

12. In concluding that the issue of whether or not the Zilk concept met "the A. & P. Tea Co. standard of invention", could be resolved as a matter of law by the Court contrary to the verdict of the jury and its answers

to the special interrogatories, both of which followed appropriate instructions on that "standard of invention."

ARGUMENT

The District Court has denied to appellants their right of trial by jury.

Both of the bases upon which the lower court supported its grant of the motion for judgment n.o.v. required a reexamination by the District Court of the ultimate fact of nonobviousness, which had been tried by the jury, and both required reconsideration of the evidentiary facts and inferences supporting that jury finding. The lower court reexamined the evidence and merely disagreed with the ultimate fact found by the twelve jurors.

Redetermination of this fact issue was error because there is substantial record evidence to support the jury's finding of nonobviousness. We submit that the jury verdict for plaintiffs should be reinstated.

The Seventh Amendment Preserves Appellants' Right of Trial by Jury

The Seventh Amendment to the Constitution of the United States specifically provides:

> "In Suits at common law * * * the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law."

Thus, the Constitution positively precludes any reexamination of facts tried by a jury unless within one of the

exceptions of the rules of the common law. The opinion of the District Court does not state that its reexamination comes within any well-recognized exception and appellants are aware of none applicable to this case.

U.S. Code, Title 28, Section 2072, which granted the Supreme Court power to prescribe rules of civil procedure for District Courts, specifically provides:

> "Such rules shall not abridge, enlarge or modify any substantive right and shall preserve the right of trial by jury as at common law and as declared by the Seventh Amendment to the Constitution."

The Supreme Court gave the constitutional right to a jury trial full force and recognition in Rule 38 of the Federal Rules of Civil Procedure:

> "(a) *Right Preserved.* The right of trial by jury as declared by the Seventh Amendment to the Constitution or as given by a statute of the United States shall be preserved to the parties inviolate."

The District Court by itself reexamining and deciding the fact of obviousness did not preserve appellants' right of trial by jury inviolate as provided by Rule 38.

The Supreme Court, at an early date, recognized the sanctity of the right of trial by jury. In *Parsons v. Bedford et al.* (1830) 3 Pet. (28 U.S.) 433, the jury brought in a verdict for plaintiffs. The defendant brought a motion for a new trial which was overruled. The defendant prosecuted an appeal from the judgment entered for the amount of the verdict. At page 446, the Court in an opinion by Mr. Justice Story, stated:

> "The trial by jury is justly dear to the American people. It has always been an object of deep interest

and solicitude, and every encroachment upon it has been watched with great jealousy. The right to such a trial is, it is believed, incorporated into and secured in every State constitution in the Union; and it is found in the constitution of Louisiana. One of the strongest objections originally taken against the Constitution of the United States, was the want of an express provision securing the right of trial by jury in civil cases. As soon as the Constitution was adopted, this right was secured by the seventh amendment of the Constitution proposed by Congress; and which received an assent of the people so general as to establish its importance as a fundamental guarantee of the rights and liberties of the people."

The Court went on to discuss the reexamination of facts tried by a jury, page 447:

> "But the other clause of the amendment is still more important, and we read it as a substantial and independent clause. 'No fact tried by jury shall be otherwise re-examinable in any court of the United States than according to the rules of the common law.' This is a prohibition to the courts of the United States to re-examine any facts tried by a jury in any other manner."

The Seventh Amendment applies in patent litigation just as it does in other types of cases. *Root v. Lake Shore and Michigan Southern Railway Company* (1882) 15 Otto (105 U.S.) 189, discusses the constitutional distinction between equity and law jurisdiction and in so doing, said, page 206:

> "* * * the 7th Amendment forbids any infringement of the right of trial by jury, as fixed by the common law. And the doctrine applies in patent cases as well as others."

In *Hansen v. Safeway Stores* (9th Cir. 1956) 238 F. 2d 336, 339, Judge Fee said:

> "The issue as to whether there subsists in a device upon which letters patent have issued novelty, utility and invention is one of fact. This explains the allowance of a jury trial in such a case. Under the Constitution, a jury trial cannot be denied if one of the parties demand it.
>
> In a jury trial of a patent case, the same rules prevail as in ordinary cases. There is no special exception simply because an alleged patent is involved. * * *"

In reaching its decision, the District Court evaluated the record evidence and, paying no heed to evidence supporting the verdict, usurped the function of the jury to find anew the ultimate fact of obviousness. This violated the Seventh Amendment to the Constitution.

Obviousness Is an Ultimate Fact to be Determined by the Jury

The basis for the jury finding of nonobviousness is U.S. Code, Title 35, Section 103:

> A patent may not be obtained though the invention is not identically disclosed or described as set forth in section 102 of this title, if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains. Patentability shall not be negatived by the manner in which the invention was made.

In its recent[1] and only construction of this section in *Graham v. John Deere Co.* (1966) 383 U.S. 1, 17, the Supreme Court characterized the condition as a "practical test" which

> "* * * lends itself to several basic factual inquiries. Under Sec. 103, the scope and content of the prior art are to be determined; differences between the prior art and the claims at issue are to be ascertained; and the level of ordinary skill in the pertinent art resolved. Against this background, the obviousness or nonobviousness of the subject matter is determined * * *."

The "level of ordinary skill" in the dispenser art and the obviousness or nonobviousness of the patented dispenser in this case had to be founded upon conflicting inferences from evidentiary facts, themselves largely not in dispute, in precisely the same manner as is the degree of ordinary care of the reasonably prudent man in a negligence case or the requisite intent in a fraud case. In each instance, there is no exact yardstick by which any of these things can be measured and the ultimate fact must be determined by the jury upon proper instructions from the court. The Supreme Court recognized this inexactness, *Graham v. John Deere Co.* (1966) 383 U.S. 1, at page 18:

> "This is not to say, however, that there will not be difficulties in applying the nonobviousness test. What is obvious is not a question upon which there is likely to be uniformity of thought in every given factual context. The difficulties, however, are comparable to those encountered daily by the courts in

[1]Decided after this trial but prior to the lower court's decision on the motion for judgment n.o.v.

> such frames of reference as negligence and scienter, and should be amenable to a case-by-case development. * * *''

So, as in negligence or scienter, in this case the ''practical test'' for obviousness is particularly one for the jury.

Obviousness or nonobviousness is a question which a jury is particularly qualified to decide. It turns largely upon the determination of what amount of improvement is obvious to a man skilled in the art. The ultimate fact is not capable of being determined with mathematical exactness and requires an analysis of the practical knowledge and the ways of men skilled in the particular art. Courts, by training, have developed the power of inductive reasoning from facts to a far greater level than the average. Hence, it is psychologically difficult for any Court to realistically place its reasoning processes on a level comparable to that of the ordinary skilled mechanic in a particular field. But the jury does not suffer that handicap because it comprises a cross-section of all of the people. Its combined thinking, therefore, more closely approaches the average human capabilities and understandings which are the direct question at issue.

The Supreme Court has long recognized the difficulty which the judicial mind has in coping with the question of invention (nonobviousness). In *Krementz v. S. Cottle Company* (1893) 148 U.S. 556, 559 the Court said:

> ''It is not easy to draw a line that separates the ordinary skill of a mechanic, versed in his art, from the exercise of patentable invention, and the difficulty is specially great in the mechanic arts, where the successive steps in improvements are numerous, and

where the changes and modifications are introduced by practical mechanics."

And in *Expanded Metal Co. v. Bradford et al.* (1909) 214 U.S. 366, 381 the same court said:

"* * * It is often difficult to determine whether a given improvement is a mere mechanical advance, or the result of the exercise of the creative faculty amounting to a meritorious invention."

More recently, Justice Frankfurter, in a partial dissenting opinion in *Marconi Wireless Co. v. U.S.* (1943) 320 U.S. 1, 60 observed:

"It is an old observation that the training of Anglo-American judges ill fits them to discharge the duties cast upon them by patent legislation."

That the jury is a fitting and proper patent fact-finder, appears in *Tucker v. Spalding* (1872) 13 Wall. (80 U.S.) 453. Mr. Justice Miller, speaking for the Court, used this language, page 455:

"Whatever may be our personal opinions of the fitness of the jury as a tribunal to determine the diversity or identity in principle of two mechanical instruments, it cannot be questioned that when the plaintiff, in the exercise of the option which the law gives him, brings his suit in the law in preference to the equity side of the court, that question must be submitted to the jury, if there is so much resemblance as raises the question at all".

United Gas Public Service Company v. State of Texas (1938) 303 U.S. 123 involved the complaint that a difficult rate case was presented to a jury. In approving the trial court procedure, the Court referred to trial by jury of

other questions of fact which were complicated. As an example, it said, page 140:

> "* * * Cases at law triable by a jury in the federal courts often involve most difficult and complex questions, as for example, in patent cases at law presenting issues of validity and infringement."

Here both the prior art and the patented dispenser are uncomplicated mechanical devices which are easily understood. The jury had before it evidence of the scope and content of the prior dispenser art, evidence of the differences between the prior art and the combination defined in the patent claims, evidence of the level of ordinary skill in the dispenser art, and even evidence of what was or what was not obvious to those skilled in the dispenser art (this brief, pages 6-7, 26-31). The jury was also instructed both in the specific language of Section 103 and by explanation of what that language meant (this brief, pages 7-9).

Who was better qualified to determine what would have been obvious to one of ordinary skill in the dispenser art—a single jurist versed in inductive reasoning and the law or twelve jurors from many walks of life and having many skills?

Historically, the issue of invention (nonobviousness) has been a factual determination

The condition of nonobviousness, which is now set out in U.S. Code, Title 35, Section 103, is merely a codification of judicial precedents such as *Hotchkiss v. Greenwood* (1851) 11 How. (52 U.S.) 248 or *A. & P. Tea Co. v. Supermarket Corp.* (1950) 340 U.S. 147 which sought to

define the general level of innovation necessary to sustain patentability [*Graham v. John Deere Co.* (1966) 383 U.S. 1, 17]. The Supreme Court, in jury cases, has consistently held that the requisite general level of innovation or "invention" is a jury question, and is not a question of law for the trial court to decide.

For example, in *Keyes et al. v. Grant* (1886) 118 U.S. 25, the prior art was not identical to the patent in suit but appeared to be rather close. The defendant contended that the improvement was not patentable because it did not require the exercise of invention. The issues came on for trial before the jury. The trial court examined the prior art and instructed the jury to return a verdict for the defendants. On appeal, the directed verdict was reversed. The Supreme Court pointed out that the view of the plaintiff, that the improvement was not the result of mere mechanical skill but sprang from a genuine effort of invention, was supported by the opinion of many experts skilled in the art. The Court, page 37, stated:

> "In our opinion this was a question of fact properly to be left for determination to the jury, under suitable instructions from the court upon the rules of law, which should guide them to their verdict. And there was evidence upon both sides of the issue sufficient to require that it should be weighed and considered by the jury in the determination of the question, and this implies that, if it had been submitted to the jury and the verdict had been for the plaintiffs, it would not have been the duty of the court to have set it aside as not supported by sufficient evidence. The court erred, we think, in withdrawing the case from the jury as it did by directing a verdict for the defendants."

The language in *Thomson Spot Welder Co. v. Ford Motor Company* (1924) 265 U.S. 445, 446, confirms those views. In that, a non-jury case, the Court itself examined the question of validity of the patent in suit because of a conflict in several lower court decisions. In so doing, this Court distinguished from the scope of review in a patent case tried by a jury, stating:

> "* * * the question whether an improvement requires mere mechanical skill or the exercise of the faculty of invention, is one of fact; and in an action at law for infringement is to be left to the determination of the jury."

Appellants have found no case in which the Supreme Court has ever approved the entry of a judgment n.o.v. or a directed verdict on the issue of invention (or obviousness) where there was any evidence on the issue to be weighed.

Re-examination of the jury's finding of nonobviousness was error

As one reason for granting judgment n.o.v. the lower court concluded that the jury finding of nonobviousness was "unreasonable" (CT. 260, 265), not that there was no evidence to support the verdict. The trial court then re-examined that ultimate fact. It considered the scope and content of the prior art (CT. 261-2), it considered the differences between the prior art and the patended dispenser (CT. 262-3), it postulated the ordinary skill in the art at the "minimum conceivable level" (CT. 264) and then it concluded that the jury was wrong and that the Zilk dispenser would have been obvious (CT. 264).

Re-examination of the ultimate fact of nonobviousness, already found by the jury, resulted in the errors specified as 1, 2, 3, 5, 6, 7 and 8. Errors 1, 2, 3 and 6 are a consequence of the improper re-examination of this fact issue. Errors 5, 7 and 8 reflect the ultimate fact of obviousness inferred by the Court from the same evidence which the jury concluded had shown that the Zilk construction was not obvious.

The District Court apparently thought that it could determine obviousness as a matter of law and completely disregard the contrary jury finding. That is not the law as appellants have pointed out in the previous two sections of this brief. *Graham v. John Deere Co.* (1966) 383 U.S. 1 did not, expressly or by implication, overrule the earlier Supreme Court decisions. The *Graham* case, itself, and those related cases considered with it, were non-jury cases. The court nowhere in its opinion expressly stated or implied that it considered obviousness to be a matter of law. Indeed, *Hotchkiss v. Greenwood* (1851) 11 How. (52 U.S.) 248, first expressing the rule of which Section 103 was a codification, was itself a jury case. There the Supreme Court approved trial court instructions regarding "invention" or nonobviousness as is now defined in Section 103.

This misconception of the nature of the issue by the District Court resulted in the further errors specified as 4 and 9. The issue of obviousness cannot be taken from the jury and treated as a matter of law.

Furthermore, that portion of the District Court opinion which is quoted in error 7 (this brief, page 11) demonstrates a misconception of the very test for obviousness

which the Supreme Court, after this jury verdict, has now set forth in *Graham v. John Deere Co.* (1966) 383 U.S. 1, 17. An improvement (here, one-handed dispensing of a plurality of fluids) over the prior art (one-handed dispensing of a single fluid by the Wheco device or two-handed dispensing of a plurality of fluids with the Magic Wand) is to be measured by whether or not the *improvement* would be obvious to one of ordinary skill if he had the prior art before him, not whether one of ordinary skill could alter the prior art after being told what the improvement was to be. In its test the District Court presupposed conception of the improvement (one-handed dispensing of a plurality of fluids). It then made inquiry only as to whether or not a way to alter the prior art and achieve the improvement would have been obvious to one of minimum conceivable skill who had been directed to make it.

Once told what to do, it would seem that the way to assemble the combination of elements should be obvious to one skilled in this art. But that is not the *Graham* test.

The "general level of innovation necessary to sustain patentability" is the condition of nonobviousness codified in Section 103

The second reason which the lower court stated for its granting of judgment n.o.v. was that "the Zilk invention fails to meet the general level of innovation necessary to sustain patentability" with a reference to *A. & P. Tea Co. v. Supermarket* (1950) 340 U.S. 147 (CT. 259, 265-6).

But the general level of innovation to which the lower court referred is the very same condition of nonobviousness defined by the judicial precedents that Section 103

codified [*Graham v. John Deere Co.* (1966) 383 U.S. 1, 17]. In this regard the Court stated:

> "We believe that this legislative history, as well as other sources, shows that the revision [Section 103 added to the Code in 1952] was not intended by Congress to change the general level of patentable invention. We conclude that the section was intended merely as a codification of judicial precedents embracing the *Hotchkiss* condition, with congressional directions that inquiries into the obviousness of the subject matter sought to be patented are a prerequisite to patentability."

The *Hotchkiss* condition was discussed, page 11:

> "This Court formulated a general condition of patentability in 1851 in *Hotchkiss v. Greenwood,* 11 How. 248. The patent involved a mere substitution of materials—porcelain or clay for wood or metal in doorknobs—and the Court condemned it, holding:
>
> > Unless more ingenuity and skill * * * were required * * * than were possessed by an ordinary mechanic acquainted with the business, there was an absence of that degree of skill and ingenuity which constitute essential elements of every invention. In other words, the improvement is the work of the skillful mechanic, not that of the inventor. At p. 267.
>
> *Hotchkiss,* by positing the condition that a patentable invention evidence more ingenuity and skill than that possessed by an ordinary mechanic acquainted with the business, merely distinguished between new and useful innovations that were capable of sustaining a patent and those that were not. The *Hotchkiss* test laid the cornerstone of the judicial evolution suggested by Jefferson and left to the courts by

Congress. The language in the case, and in those which followed, gave birth to 'invention' as a word of legal art signifying patentable inventions. Yet, as this Court has observed, '[t]he truth is the word [''invention''] cannot be defined in such manner as to afford any substantial aid in determining whether a particular device involves an exercise of the inventive faculty or not.' *McClain v. Ortmayer,* 141 U.S. 419, 427 (1891); *A. & P. Tea Co. v. Supermarket Corp., supra,* at 151. Its use as a label brought about a large variety of opinions as to its meaning both in the Patent Office, in the courts, and at the bar. The *Hotchkiss* formulation, however, lies not in any label, but in its functional approach to questions of patentability. In practice, *Hotchkiss* has required a comparison between the subject matter of the patent, or patent application, and the background skill of the calling. It has been from this comparison that patentability was in each case determined.''

A. & P. Tea Co. v. Supermarket (1950) 340 U.S. 147 merely reiterated the same principle [*Graham v. John Deere Co.* (1966) 383 U.S. 1, 17].

Thus, application of this ''general level of innovation'' by the District Court required the same factual determination now specified by the Supreme Court in *Graham* for application of Section 103.

Here that fact determination had already been made by the jury. Under the guarantees of the Seventh Amendment it could not be re-examined by the trial court as a factual issue, or under the guise of a question of law or as a test for the ''general level of innovation necessary to sustain patentability''. The latter resulted in the additional errors specified in 10, 11 and 12.

Substantial Record Evidence Does Support the Verdict and the Jury Finding That the Claimed Combination Was Not Obvious

There is positive record proof that the improvement made by Zilk was not obvious. The jury's eight interrogatory answers (CT. 185b-185e) on this issue are fully supported by the evidence. This record is quite different from that in *Griffith Rubber Mills v. Hoffar* (9th Cir. 1963) 313 F. 2d 1 upon which the lower court relied (CT. 260, 265). In *Griffith* this Court in reversing the denial of a motion notwithstanding the verdict noted, page 5:

> "There was no objective evidence that the combination was less obvious than it appears. There was no showing that Hoffar's muffler dealt with a problem which had concerned the industry over a substantial period and which others had sought to solve without success. So far as was shown, Hoffar was the first to make an all-elastomer muffler with a slit-baffle wall only because he was the first skilled in the art who directed his attention to the problem of creating an effective muffler that would not corrode."

We here presented substantial objective evidence to the jury upon which it could, as it did, conclude that the Zilk improvement was not obvious in July, 1957.

Barmaster failed to conceive the patented combination when faced with exactly the same problem to be solved

Plaintiff Zilk testified how he and others in the dispenser industry continuously strived to speed up the work of a bartender in mixing drinks (RT. 58-61). As a result he developed an early soda dispensing device (DX A; RT. 46-49) and sold the Carbonic lever operated dispenser

(DX C; RT. 58-59). Others developed the "Wheco" or "Speedbar" dispenser (DX B). Barmaster developed a bar-mounted valve block (DX D) to which was attached a flexible hose with nozzle (DX E) which formed the "Magic Wand" (DX F). The lower court considered it to be "foremost of the prior art devices" (CT. 261).

All of these prior art dispensers had one deficiency. The bartender could not dispense with one hand more than a single bar mix (RT. 106-126). This was the problem which the Zilk dispenser solved (PX 1, Col. 1, lines 28-31), among other things, by locating push buttons on the nozzle grouped in a way which they could be operated by one hand without a change in grip on the dispenser handle (RT. 38-41). This left the other hand free for other chores.

At least as early as March of 1956 Barmaster was faced with resolving the same problem, which Zilk solved, when it endeavored to build a dispenser for a one-armed bartender. The article in *Voice of Eating* (DX G, DX I) shows that Barmaster did not modify its "Magic Wand" construction to provide the patented combination and accomplish its result. Instead, Barmaster designed a foot treadle mechanism which as an accessory (PX 12) operated the valves on its bar mounted valve block (DX D).

Thus, affirmative evidence before the jury shows that the patented combination of elements was not obvious to those as skilled in the dispenser art as Barmaster, the manufacturer both of a later infringing dispenser (PX 4) and of the prior art "Magic Wand" (DX D, DX E, DX F) which the District Court considered "foremost of the prior art devices". This is the most positive kind of

evidence from which a jury could conclude that what Zilk did was not obvious even to those highly skilled in the bar mix dispensing field.

The failure of the lower court even to mention the Barmaster foot treadle device in its opinion confirms the appropriateness of a jury finding on the issue of obviousness. In a similar context in *Bailey v. Central Vermont Railway, Inc.* (1943) 319 U.S. 350, defendant moved for a directed verdict at the close of the evidence. The trial court denied the motion and the jury returned a verdict for the plaintiff. On appeal, the Supreme Court of Vermont reversed, holding that the motion for the directed verdict should have been granted because negligence was not shown. The U.S. Supreme Court, in turn, reversed the Vermont Supreme Court and reinstated the jury verdict. In speaking of the issue of negligence, the Supreme Court stated, page 353:

> "* * * The debatable quality of that issue, the fact that fair-minded men might reach different conclusions, emphasizes the appropriateness of leaving the question to the jury. The jury is the tribunal under our legal system to decide that type of issue (Citation omitted) as well as issues involving controverted evidence (Citation omitted). To withdraw such a question from the jury is to usurp its functions."

And in *Tennant v. Peoria & Pekin Union Railway Company* (1944) 321 U.S. 29 the Court said, page 35:

> "* * * Courts are not free to reweigh the evidence and set aside the jury verdict merely because the jury could have drawn different inferences or conclusions or because judges feel that other results are more reasonable."

In *Lavender v. Kurn* (1946) 327 U.S. 645, the Court stated, page 653:

> "* * * But where, as here, there is an evidentiary basis for the jury's verdict, the jury is free to discard or disbelieve whatever facts are inconsistent with its conclusion. And the appellate court's function is exhausted when that evidentiary basis becomes apparent, it being immaterial that the court might draw a contrary inference or feel that another conclusion is more reasonable."

We submit that conversion of a "Magic Wand" into a treadle operated dispenser instead of the claimed Zilk combination is, in and of itself, sufficient evidence to support the jury verdict. That fact is such that reasonable men could have drawn different inferences of obviousness from it. Judgment n.o.v. therefore is in conflict with the foregoing decisions of the Supreme Court which protect a party's right to a jury determination of fact issues.

Other substantial record evidence further supports the jury finding of nonobviousness.

Although the component elements were well-known, no prior art combined them in the patented combination

The fifteen patents (DX L, M, N, O-1 through O-13) in evidence, as well as the prior art devices, show that there was considerable activity in the dispensing field. Even though each component element was available to those working with dispensers for some thirty years, no one put these elements together in the manner as did Zilk, nor did anyone accomplish the same result. From these facts also the jurors could infer that the Zilk improvement was not obvious [*Loom Co. v. Higgins* (1881) 105 U.S. 580, 591].

Immediate appearance on the market of infringing dispensers

Witnesses De Ceasare, Zilk and Kearns all testified that McCann, Barmaster, Carbonic and other infringing devices appeared on the market shortly after the Zilk Flomatic dispensers were placed in use (RT. 117, 152-155). This immediate response of bar equipment suppliers long in the business also supports a jury inference that the patented improvement was not obvious even to these skilled manufacturers [*Moist Cold Refrigerator Co. v. Lou Johnson Co.* (9th Cir. 1957) 249 F. 2d 246, 254].

Prior art bar mix dispensers were abandoned in favor of the patented dispenser

The evidence showed that practicallly all prior art bar mix dispensers were abandoned upon general availability of the patented dispenser. Without contradiction John Kearns testified that the Carbonic lever operated valve (DX C), the Barmaster bar mounted device (DX D), the Wheco device (DX B) and even the Magic Wand itself (DX D, E and F) were generally abandoned when the patented devices, including those of Flomatic, Barmaster, Carbonic and McCann became available on the market (RT. 151-156). The jury certainly was entitled to infer from these facts that the Zilk device was an improvement which solved a problem in the industry, and, in spite of all the activity in the field, must not have been obvious [*Goodyear v. Ray-O-Vac Co.* (1944) 321 U.S. 275, 279].

Thus, there is substantial evidence in this record to support the jury finding of nonobviousness and the general verdict for plaintiffs. As held by this Court in *Moist Cold Refrigerator Co. v. Lou Johnson Co.* (9th

Cir. 1957) 249 F. 2d 246, 253-4, where there is substantial evidence on an issue to be weighed, the entry of judgment n.o.v. is not proper.

CONCLUSION

Appellants submit that the District Court by entering judgment n.o.v. following its re-examination of the ultimate fact of obviousness, has denied to them their right to trial by jury which is preserved by the Seventh Amendment.

The jury verdict should be reinstated.

Dated, San Francisco, California,
January 6, 1967.

Respectfully submitted,
Carl Hoppe,
James F. Mitchell,
Attorneys for Appellants.

Certificate of Counsel

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Carl Hoppe,
Attorney for Appellants.

(Appendix Follows)

Appendix

Appendix

LIST OF PLAINTIFFS' EXHIBITS

	Description	Identified	Offered	Received
1	Original letters patent 2,887,250	4	4	4
2	Patent License Agreement	7	9	9
3A	Zilk dispensing unit	15	15	15
3B	Zilk transformer	15	15	15
4	Barmaster dispenser	15	15	15
5	Carbonic dispenser	15	15	15
6	McCann dispenser	15	15	15
7	Chart—claim 1	37	42	42
8	Chart—patent drawings	37	42	42
9A	Later model of Zilk dispenser	15	15	15
9B	Later model of Zilk transformer	15	15	15
10	Demonstrative dispensing unit	40	42	42
11	Barmaster equipment mounted on bar	41	42	42
12	Barmaster brochure	115	116	116

LIST OF DEFENDANT'S EXHIBITS

	Description	Identified	Offered	Received
A	Zilk patent 2,820,675	47	48	48
B	Circular of Wheco device	51	207	207
C	Carbonic stationary-head dispensing apparatus	58	207	207
D	Barmaster dispenser mounted on bar top	64	207	207
E	Photostatic copy of literature of Magic Wand	68	207	207
F	Magic Wand dispenser	74	207	207
G	Pages from "The Voice of the Eating Industry"	133	207	207
H	Barmaster literature	135	207	207
I	Restaurant Service Magazine, March, 1957	138	138	138
J	Zilk application, serial No. 695,870	194	194	194
K	File wrapper of patent 2,887,250	194	194	194
L	Patent, R. E. Parks, 2,565,084	197	197	197
M	Patent, Brown, 2,008,850	198	198	198
N	Patent, Welch, 2,745,913	198	198	198
O-1	through O-13, prior art patents	206	207	107
P	Interrogatories of defendants, and answers of plaintiffs, second set	203	203	203
Q	Interrogatories of defendants, and answers of plaintiffs, third set	203	203	203
R	Patent license agreement	205	205	205
S	McCann dispenser	205	207	207

NO. 21,194

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

CARL S. ZILK and FLOMATIC SALES CORPORATION, an Oregon corporation,

Appellants,

v.

DEATON FOUNTAIN SERVICE, a partnership comprised of William F. Deaton and C. J. DeCeasare,

Appellee.

APPELLEE'S BRIEF

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

STATUTES PAGE

OTHER AUTHORITIES PAGE

NO. 21,194

UNITED STATED COURT OF APPEALS

FOR THE NINTH CIRCUIT

CARL S. ZILK and FLOMATIC SALES CORPORATION, an Oregon corporation, Appellants,	)
v.	)
DEATON FOUNTAIN SERVICE, a partnership comprised of William F. Deaton and C. J. DeCeasare, Appellee.	)

APPELLEE'S BRIEF

This is an appeal from an order of the District Court granting the motion of Defendant Deaton* for Judgment Notwithstanding the Verdict.

*For convenient reference throughout this brief, the parties hereto will be referred to as "Appellants" or "ZILK" and "Appellee" or "DEATON".

Jurisdiction of the District Court was based upon 28 USC §1338(a). The Complaint alleged a claim for patent infringement arising under the acts of Congress relating to patents (CT. 1) and the Answer admitted the jurisdictional facts (CT. 31, 118).

Jurisdiction of this Court is based on 28 USC §1291.

STATEMENT OF THE CASE

The District Court granted Appellee's motion for Judgment Notwithstanding the Verdict on two separate and distinct grounds: (1) That no reasonable jury could have concluded that the Zilk invention was non-obvious under 35 USC §103, and (2) The Zilk invention fails to meet the general level of innovation necessary to sustain patentability.

On the issue of unobviousness under §103 of the Statute, the Court said:

> "The Court therefore concludes that despite the fact that a small amount of objective evidence of non-obviousness was tendered, Cf. Griffith Rubber Mills v. Hoffar, supra, (and taking fully into account the factors of secondary consideration such as unsatisfied need and commercial success), the jury was unreasonable in finding that the Zilk patent was non-obvious. As a result the Zilk patent is invalid as a matter of law

statutory mandates established by 35 USC §103." (CT. 265)

On the issue of general level of innovation, the Court said:

"Entirely separate from the Section 103 issue, the Zilk concept does not meet the A & P Tea Co. standard of invention. The evidence in this case failed completely to show that by the arrangement of old elements, plaintiff obtained any "unusual or surprising consequences" from his combination as called for in the A & P Tea Co. decision. (Reaffirmed in Graham v. John Deere, supra.) All that Zilk achieved was a more convenient location for the switch buttons permitting a one handed operation, which was possible with a single fluid in the "Wheco" device. It has long since been the law that mere relocation of an element of an old combination does not amount to patentable invention. Photochart, et al v. Photo Patrol, et al, 189 F.2d 265. Weyerhauser Timber Co. v. Royal Container Co., 128 USPQ 70,71. This maxim holds true regardless of how useful or convenient the relocation is. Cuno Corp. v. Automatic Devices Corp., 314 U.S.

long line of judicial precedents that it may properly be resolved as a matter of law by the Court.11/" (CT. 265,266)

The §103 issue had been submitted to the jury, but the A & P test had not been submitted to the jury as the Court indicated in Footnote 11, "The A & P Tea Co. test was not submitted to the jury in the instructions as the standard for invention because of the confusion over the possible preemption by Section 103, preceding the Graham decision." (CT. 266).

Appellee's Motion for Judgment n.o.v. was accompanied by a Motion for New Trial. (CT. 186 & 187) While the Court granted the former Motion, it did not pass upon the latter Motion. By Stipulation (RT. 342-3) Appellee's defenses of patent misuse were to be submitted to the Court without the jury after determination of the Motion for Judgment n.o.v. (RT. 350-1). The trial Court has not passed on these defenses.

QUESTION PRESENTED

We do not concur in Appellants' statement of the question presented on this appeal, at page 10 of their Brief. The question is not whether the District Court denied to Appellants their asserted right of trial by jury, but whether the Court had the power and the duty to grant the Motion for Judgment n.o.v. when its examination of the case led it to the inescapable conclusion that the Letters Patent in suit were invalid as a matter of law. As indicated by the two grounds mentioned in the preceding section of this Brief, the question is

avorable to the Appellant, could reasonable men conclude that he Zilk invention was unobvious? (2) Does the Zilk invention rise to the standard of invention set forth in A & P Tea Co. . Supermarket, 340 U.S. 147, 87 USPQ 303 (1950), and Graham . John Deere, 383 U.S. 1, 148 USPQ 459 (1966)?

The appeal presents also a subordinate issue which s the automatic consequence of F.R.C.P. Rule 50(c). The istrict Court, having granted Appellee's Motion for Judgment otwithstanding the Verdict, failed to rule on Appellee's lternative Motion for a New Trial and, insofar as the failure o rule may be taken as a denial thereof, Appellee asserts rror in that denial.

SPECIFICATION OF ERROR

Appellee asserts as error that its Motion for New rial should have been granted in view of F.R.C.P. Rule 50 c)(1) which provides in pertinent part: "If the Motion for udgment Notwithstanding the Verdict, provided for in sub- ivision (b) of this Rule, is granted, the Court shall also ule on the Motion for a New Trial, if any, by determining hether it should be granted if the Judgment is thereafter acated or reversed, and shall specify the grounds for grant- ng or denying the Motion for New Trial. . . .In case the otion for a New Trial has been conditionally denied, the ppellee on appeal may assert error in that denial; . . ."

The Propriety of Judgment n.o.v.

The main argument set forth in Appellants' Brief is the age-old proposition that the District Court denied to Appellants their right of trial by jury. In an erroneous interpretation of the law Appellants argue that the District Court "usurped the function of the jury to find anew the ultimate fact of obviousness". It is asserted that this violated the Seventh Amendment to the Constitution.

The fallacy of this argument is made apparent by an examination of the holdings of the United States Supreme Court in Graham v. John Deere Co., supra. It was there held (148 USPQ at 467) that "the ultimate question of patent validity is one of law". This being so, it follows, as the night follows the day, that a jury verdict finding a patent valid cannot be deemed so sacrosanct as to preclude the trial court from an examination of such verdict to determine whether the patent is valid or invalid as a matter of law.

If this proposition ever admitted of any doubt, it was laid to rest by the decision of this Court in Bentley v. Sunset House Distributing Corp., 359 F.2d 140, 149 USPQ 152 (9th Cir., 1966). That decision followed closely on the heels of the Supreme Court's decision in GRAHAM, and the Court made the following observations which must be taken as a complete answer to Appellants' argument about the propriety of the granting of a judgment notwithstanding the verdict in a patent case:

Bentley asserts that the district court's grant of judgment n.o.v. effectively deprives him of the jury trial to which the Constitution entitles him.

The appropriate accommodation of the constitutional guarantee of jury trial and the necessity of ensuring that the constitutional and statutory standards of patentability are met in particular cases has been a subject of much debate and exploration in the cases. But we think that debate was foreclosed by Graham v. John Deere Co., 34 U.S. L. Week 4119, 148 USPQ 459, decided February 21, 1966. There it was held that 'the ultimate question of patent validity is one of law.' This, in substance, has long been the position of this court, as Judge Pope noted in his concurring opinion in Bergman v. Aluminum Lock Shingle Corp., 9 Cir., 1957, 251 F.2d 801, 809-13, 116 USPQ 32, 38-41. See e.g., Griffith Rubber Mills v. Hoffar, 9 Cir., 1963, 313 F.2d 1, 136 USPQ 334. It is the position adopted by other circuits, see e.g., Hygenic Specialties Co. v. H.G. Salzman, Inc., 2 Cir., 1962, 302 F.2d 614, 617, n.6, 133 USPQ 96, 99; Packwood v. Briggs & Stratton Corp., 3 Cir., 1952, 195 F.2d 971, 973, 93 USPQ 274, 275; Monroe Auto Equip. Co. v. Heckethorne

406, 412, 141 USPQ 549, 554-555. If the patents are invalid as a matter of law, the court not only had the power, but it was its duty, to grant the motion for judgment n.o.v. Himes v. Chadwick, 9 Cir., 1952, 199 F.2d 100, 95 USPQ 59; Packwood v. Briggs & Stratton, supra; see Griffith Rubber Mills v. Hoffar, supra; Berkeley Pump Co. v. Jacuzzi Bros., Inc., 9 Cir., 1954, 214 F.2d 785, 102 USPQ 100." (149 USPQ at 154)

It is noteworthy that in BENTLEY there were some parallels to the case at bar which are deadly. There, as here, the case involved a claim of patent infringement under 35 USC §281. There, as here, the jury returned a verdict for the patentee and assessed damages. There, as here, the Court granted defendant's Motion for Judgment Notwithstanding the Verdict. The only procedural difference between the cases was that in BENTLEY the district judge also granted, conditionally, the defendant's Motion for a New Trial, whereas here the District Court did not pass on the Motion for a New Trial.

As indicated by the Supreme Court in GRAHAM, supra, the question of patentability, while a question of law, involves certain factual inquiries. The existence of factual matters does not, however, place the ultimate decision in the hands of the jury. The factual matters do not require resolution by the jury where the facts are not

in dispute, and where it is unnecessary to weigh the credibility of witnesses. As the Court said in the landmark case of Brady v. Southern Railroad, 320 U.S. 476, 479-480 (1943)

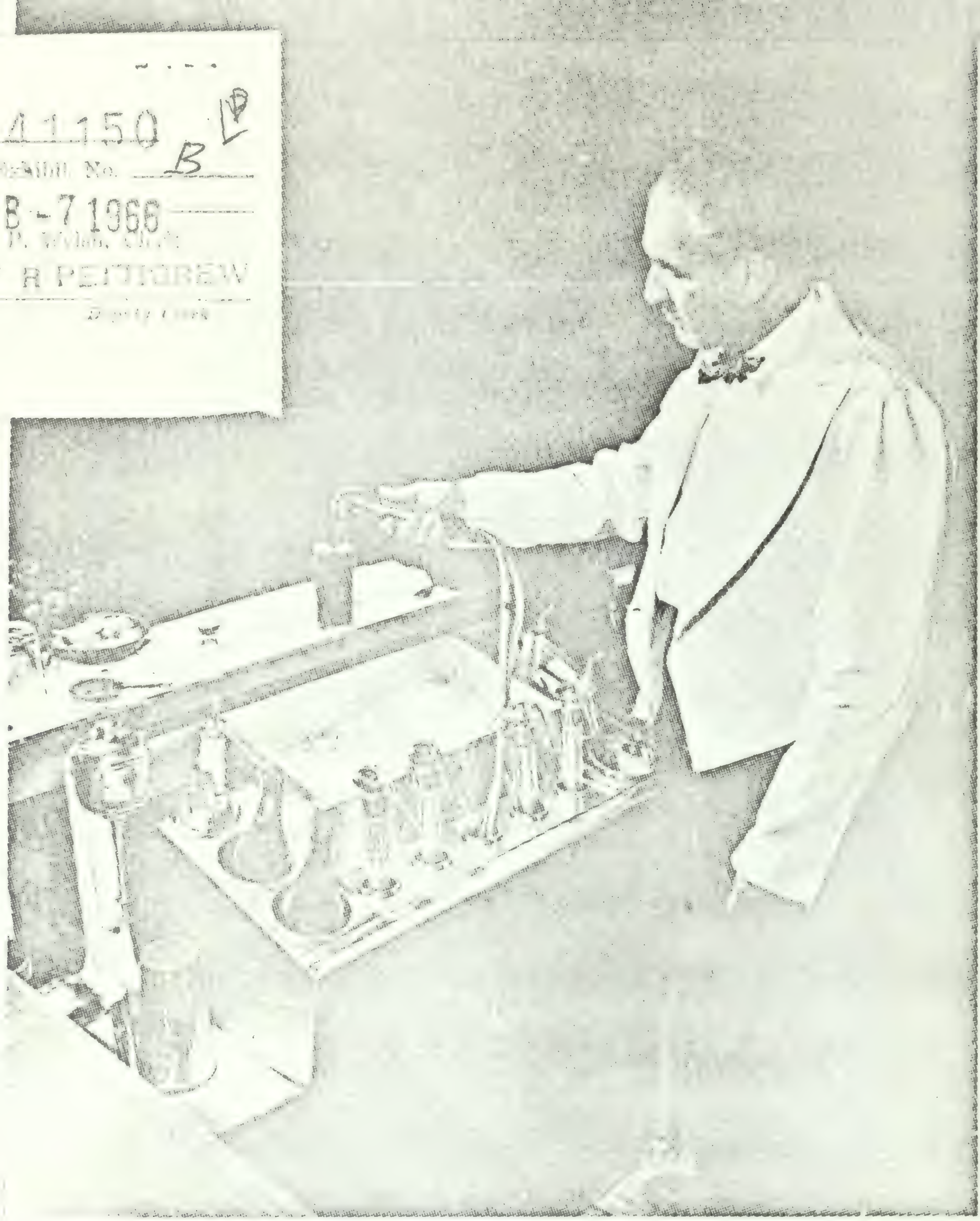
> "When the evidence is such that without weighing the credibility of the witnesses there can be but one reasonable conclusion as to the verdict, the court should determine the proceeding by non-suit, directed verdict or otherwise in accordance with the applicable practice without submission to the jury, or by judgment notwithstanding the verdict. By such direction of the trial the result is saved from the mischance of speculation over legally unfounded claims."

The matters which are factual matters in a patent case are (1) What was the prior art?, (2) What did Zilk do to improve upon the prior art?, and (3) What was the level of ordinary skill in the art? Graham v. John Deere, supra; Griffith Rubber Mills v. Hoffar, 313 F.2d 1, 136 USPQ 334 (9th Cir., 1963). In the present case, the facts are so clear that reasonable men could not differ on the facts, and it is unnecessary to weigh the credibility of witnesses in finding the facts. Beyond these factual matters, the ultimate test of obviousness under 35 USC §103 is a question of law, and the ultimate test of whether or not the Zilk invention measures up to the "standard of invention" is a question of law. For these reasons, the case is properly decided on

lants' right to jury trial. See Graham v. John Deere, supra, Bentley v. Sunset House Distributing Corp., supra. See also, Stallman v. Casey Bearing Company, 244 F.2d 905, 114 USPQ 36 (9th Cir., 1957), Cert denied 355 U.S. 864, where the granting of Judgment n.o.v. was affirmed; Griffith Rubber Mills v. Hoffar, supra, where the denial of the Motion for Judgment n.o.v. was held to be reversible error. cf. Walker v. General Motors, 362 F.2d 56, 159 USPQ 472 (9th Cir., 1966), where a Motion for Summary Judgment of patent invalidity was sustained in the face of the plaintiff's demand for jury trial; Monroe Auto Equipment v. Heckethorn Mfg. Co., 332 F.2d 406, 141 USPQ 549 (6th Cir., 1964) Cert. denied 379 U.S. 888, where a patent was held invalid as a matter of law after trial by the court in face of a jury demand. As Judge Hastie said in Packwood v. Briggs & Stratton Corp.[1], 195 F.2d 971, 93 USPQ 274, 275 (3rd Cir., 1952), Cert. denied 344 U.S. 844.

> "This finding of invention and validity was very clearly wrong. A jury in a patent case is not free to treat invention as a concept broad enough to include whatever discovery or novelty may impress the jurors favorably. Over the years the courts of the United States, and partic-

1. Cited with approval in Berkeley Pump Co. v. Jacuzzi Bros., Inc., 214 F.2d 785; 102 USPQ 100 (CA 9), and in Himes v. Chadwick, 199 F.2d 100; 95 USPQ 59 (CA 9).



EACH UNIT IS A COMPLETE COCKTAIL STATION

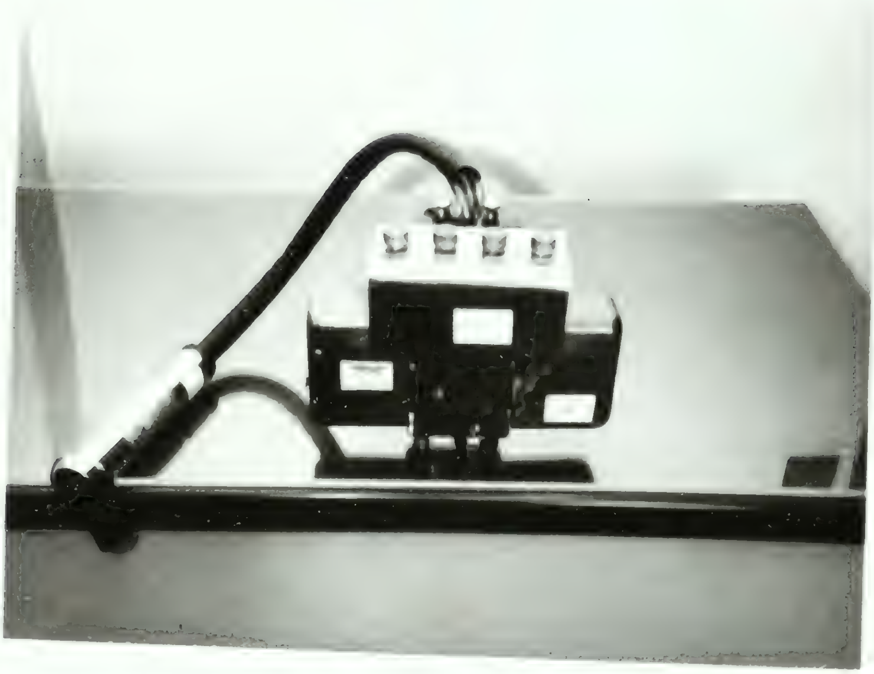
Every WHECO unit contains a complete cocktail setup — divided ice-bin, for crushed and cubed ice, six bottle wells, and five different mixes (dry soda, water and three flavored sodas) all positioned for speedy barman action. Iced air constantly circulates throughout entire cabinet.

> ing implicit in the scheme and purpose of the patent laws which aids in the construction of their general language. In this process, rules and standards have been developed for use as guides to the systematic and orderly definition and application of such a conception as invention in accordance with what the courts understand to be the true meaning of the Constitution and the patent laws. Once such standards and rules are authoritatively announced any finding of 'invention' whether by a court or a jury must be consistent with them."

The Prior Art

The principal prior art structures involved in this case are the Bar-O-Matic Magic Wand device (Exhibit F mounted on Exhibit D, hereinafter referred to as the Magic Wand) and the Wheco-Speedbar device (Exhibit B, hereinafter referred to as Wheco). These are the prior art devices on which the district judge based his Judgment n.o.v. (CT. 261, 262), and these are the prior art devices which Zilk actually had in mind at the time he conceived of his invention (RT. 53, 84 and 86).

The Wheco device, as shown in the adjacent photographic copy of Exhibit B, was a bar mix dispenser which had several hoses with a valve handle mounted on the end of each



soda water, etc.) which was to be dispensed. When a bartender used the Wheco device, he selected the hose which carried the mix he wanted and moved the valve handle on the end of the hose to a position over a beverage glass. He then operated a push lever on the handle, operating the lever with the thumb of the hand which held the handle, to dispense the bar mix from the hose into the glass. This was a "one-handed operation" for dispensing one bar mix with each hose. (RT. 53-55). At the time Zilk made the invention set forth in the patent in suit, Zilk was engaged in the bar equipment business in Portland, Oregon, and the Wheco device was sold or leased in the Portland area in competition with Zilk, and Zilk had personally observed the device prior to the making of his "invention" and more than one year prior to his application (RT. 53).

The Magic Wand, shown in the adjacent photograph of Exhibits D and F, was a bar mix dispenser which had a stationary valve block mounted on a bar and movable nozzle and handle connected to the valve block by a multi-conduit flexible hose. An electrical switch push button was mounted on the valve block for each of several bar mixes to be dispensed by the device, and the valve block contained electrically operated valves connected to one of the switches and one of the conduits in the hose for controlling the flow of each bar mix through the hose when the corresponding switch button was operated. When a bartender used the Magic Wand device, he picked up the nozzle handle with one hand, moved the nozzle to a

position over a beverage glass on the bar and then, using the other hand, pressed one of the switches to open the corresponding valve so that one beverage would flow through the hose and out of the nozzle into the glass. The bartender could then move the nozzle to a position over another glass and operate the same or a different switch button to dispense the same or a different bar mix into the second glass (RT. 64-78). The basic elements of the Magic Wand device described above were connected together by electrical circuit elements illustrated in Exhibit H which are substantially identical to the corresponding elements in the Zilk invention.

The Differences Between The Prior Art and The Claims in Issue

The differences between the Magic Wand and the Zilk invention are most apparent from a comparison of Exhibit S and the Magic Wand device. Exhibit S is one of the devices alleged to infringe the patent and hence the Zilk invention will be found in this Exhibit. The differences between Exhibit S on the one hand and Exhibits F & D on the other hand are the improvements in the art which Zilk "invented". There are no factual disputes about these differences because the physical Exhibits speak for themselves and many of the parts of the Exhibits are interchangeable.

A physical comparison of these Exhibits demonstrates that Zilk's invention consists of nothing more than moving the switch buttons on the Magic Wand from the valve block (the blue element) to the end of the flexible hose and running the electric wires for the switches along the hose. The switch

counterparts on the Magic Wand, but they are still switch buttons and electric switches with the same functions and connected together in exactly the same way as the counterparts on the Magic Wand.

Similarly, analysis of Claim 1 of the Zilk patent demonstrated that Zilk's invention consists of nothing more than moving the switch buttons on the Magic Wand to the end of the flexible hose and running the electric wires for the switches along the hose. Thus, in the text of Claim 1 reproduced below, we have underlined several groups of words. When these words are left out of the claim, the claim becomes a word picture of the Magic Wand.

> "1. A dispensing apparatus comprising a dispensing head having a nozzle, a handle for said head, a remotely located valve means to selectively regulate the supply of a plurality of fluids to said head, a plurality of flexible conduits extending from said valve means to said head and communicating with said nozzle to deliver said plurality of fluids to said nozzle, electric power means for said valve means for operating said valve means to selectively supply said fluids to said head, switch means <u>carried by said handle</u> to control the supply of electrical energy to said power means, flexible electrical conductors extending from said power means to said switch means to enable said control

tors together in contiguous relationship to provide a single flexible member enabling said head to be moved freely relative to said valve means, said handle having a shape fitting in one hand of the operator with the nozzle located adjacent such hand, said switch means including a plurality of independently operable push buttons, each push button being operable when actuated to control operation of the valve means to cause a supply of at least one selected fluid to said nozzle through said conduits, said push buttons being grouped on said handle to provide for operation of any push button by the thumb or a finger of said one hand of the operator without changing the grip of such one hand on the handle thus freeing the other hand of the operator for other uses while permitting the selective discharge of a plurality of fluids from said nozzle."

The only structural features defined by the underlined words are the relocation of the switches and the running of the wires along the hose.

The Level of Ordinary Skill in The Art

The District Judge postulated the level of ordinary skill in the art at "the minimum conceivable level" (CT. 264). Several factors should be considered in evaluating this "min-

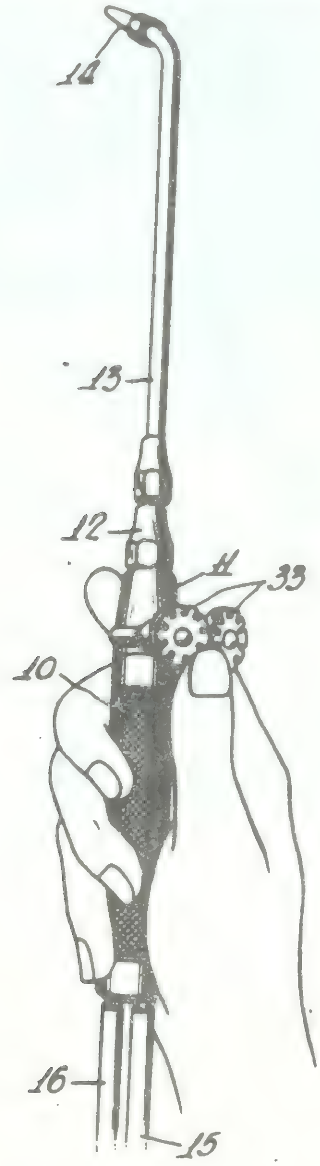
mind that we are determining only whether or not it is within the skill of the art to relocate the electrical switches on the Magic Wand from the valve block to the movable handle with a corresponding extension of the wires for those switches. There are several undisputed facts in the record which might be considered in determining this minimum conceivable level of skill.

In the first place, we might consider the rapidity with which Zilk actually conceived of the invention when he was first introduced to the Magic Wand device. Zilk conceived of the patented dispenser on July 19, 1957 (RT. 43-44), and as mentioned above, the Wheco device was sold or leased in competition with Zilk at that time, and Zilk was aware of the Wheco device at that time. This conception of the patented dispenser by Mr. Zilk occurred at the time of a meeting with a Mr. McCampbell on July 18 or 19, 1957 (RT. 86). At this meeting, Mr. McCampbell showed to Zilk literature illustrating the Magic Wand and offered to sell Magic Wand devices to Zilk (RT. 85). In this very meeting with Mr. McCampbell, when Zilk was first introduced to the Magic Wand device, Zilk told Mr. McCampbell that the Magic Wand device should be modified by relocating the push buttoms on the movable head instead of the valve block (RT. 81-87).

Of course, the activities of Zilk in conceiving of the invention are not controlling in determining the level of skill in the art. However, the level of skill in the art is shown affirmatively by the wide variety of prior dispensers shown in Exhibits M and O. These prior dispensers show that

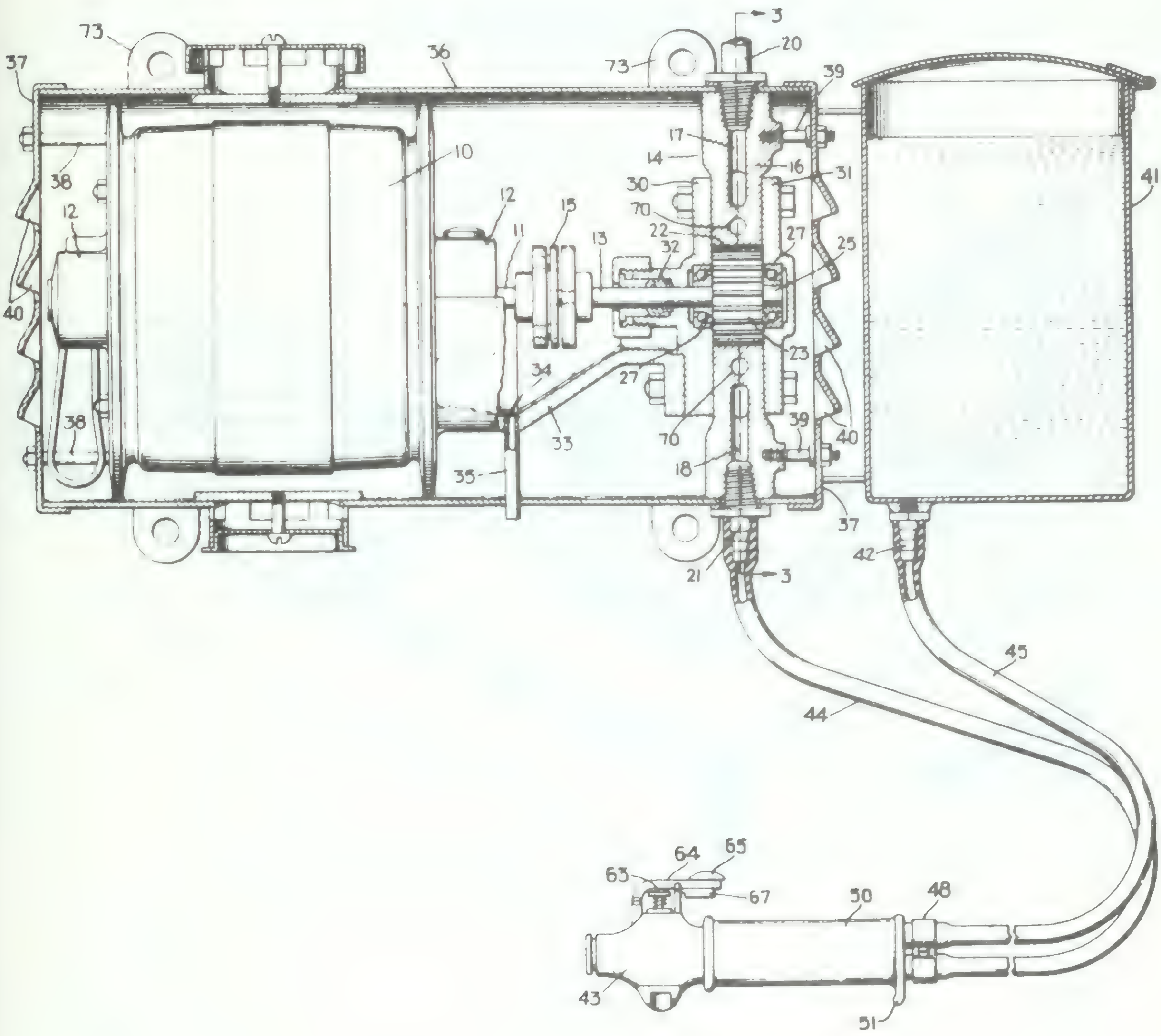
the operating buttons for dispensers on the handle of a flexible hose so that the dispenser could be operated by the thumb of the hand which held the handle. In some of these prior art devices, the operating button or lever opened a valve in the handle. The Buttner Patent, Ex. O-1, shows a torch having a handle 10 with a nozzle 14 mounted on the end of a pair of flexible hoses 15 and 16. Two rotary valves 33 are mounted on the handle for manipulation by the thumb of the hand that holds the handle to control the delivery of oxygen and acetylene through the nozzle.

<u>Buttner Patent, Ex. O-1</u>



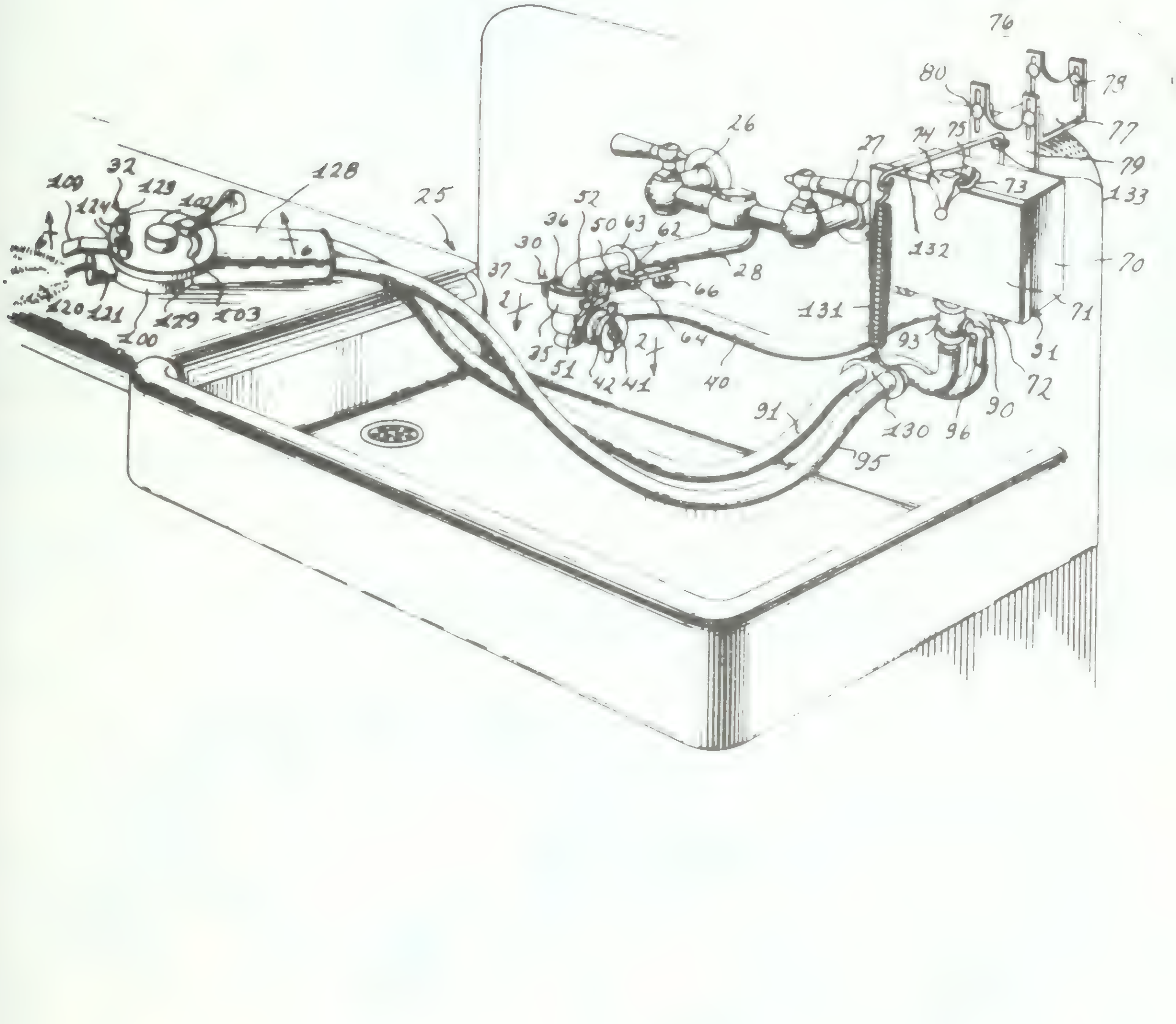
The Lingard Patent, Ex. O-3, shows a washing device hav-
ng a handle 50 with a nozzle 43 mounted on the end of a pair of
lexible hoses 44 and 45. A push button 65 is mounted on the
ndle for opening a valve 63 to control the delivery of soap
d water from the nozzle.

<u>Lingard Patent, Ex. O-3</u>



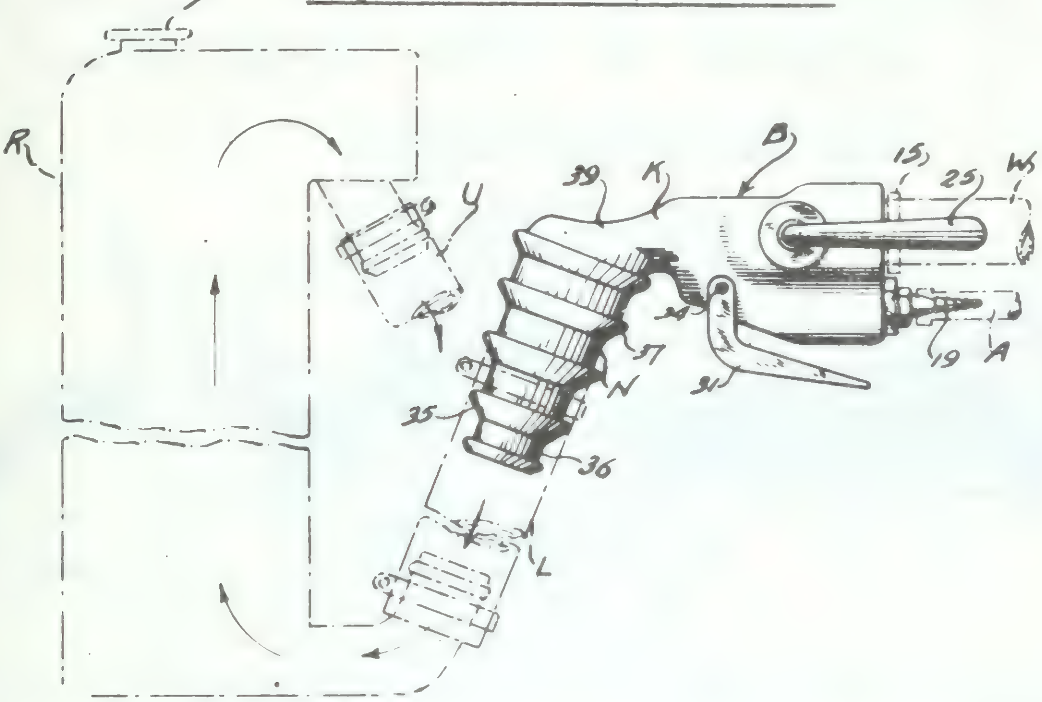
The Paddock Patent, Ex. O-4, shows another dishwasher having a handle 128 and nozzle 109 on a pair of flexible hoses 91 and 95 with a valve 103 mounted on the handle.

<u>Paddock Patent, Ex. O-4</u>



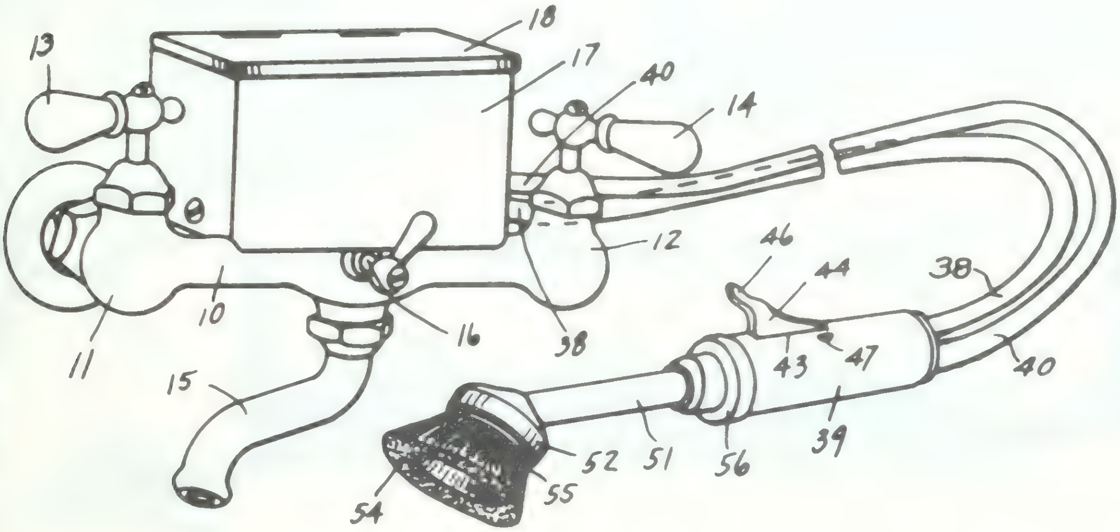
omobile radiators where the gun has a handle B with a nozzle mounted on the ends of air and water hoses A and W with a pain valve levers 25 and 31 mounted on the handle.

Hopkins Patent, Ex. O-5



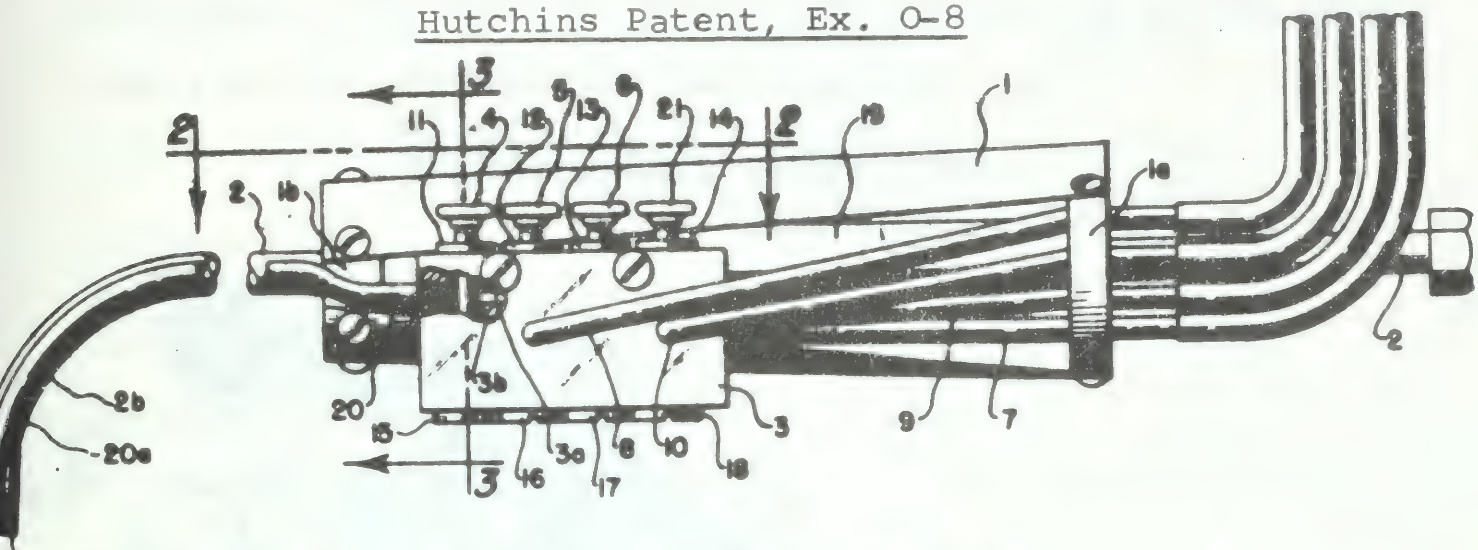
The Manville Patent, Ex. O-6, shows another dishwashing evice having a handle 39 and nozzle 52 mounted on the end of a air of hoses 38 and 40 by which water and soap flow to the noz-le. A valve lever 46 is mounted on the handle for controlling luid flow.

Manville Patent, Ex. O-6



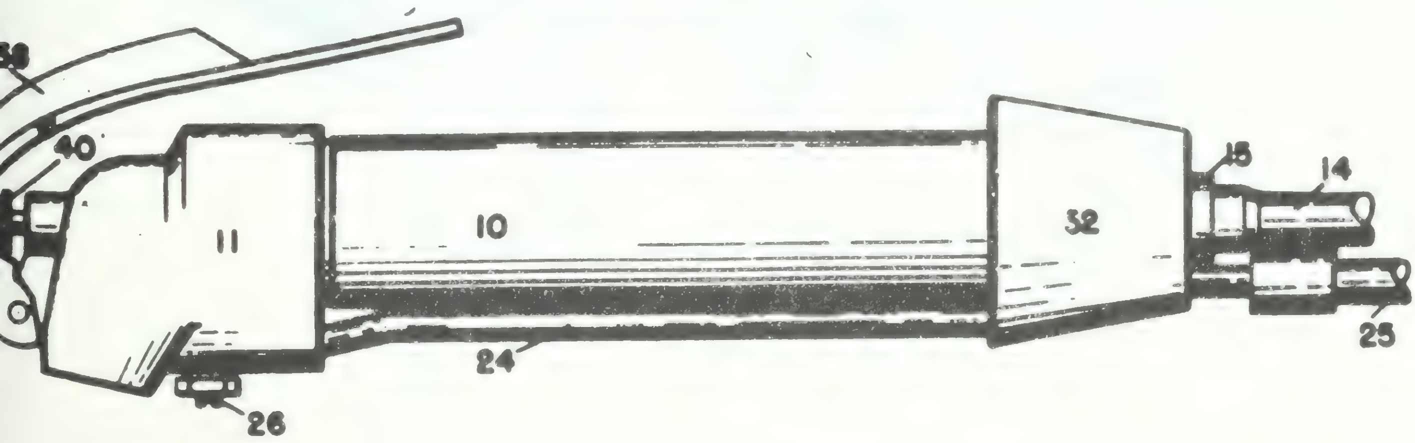
which is a device used by dry cleaners for dispensing spot removing fluids onto fabrics. The Hutchins spotting gun contains a handle 1 with a nozzle 2 mounted on the end of four hoses with four valves 4, 5, 6 and 21 mounted on the handle for controlling the flow of cleaning fluids from the device.

Hutchins Patent, Ex. O-8



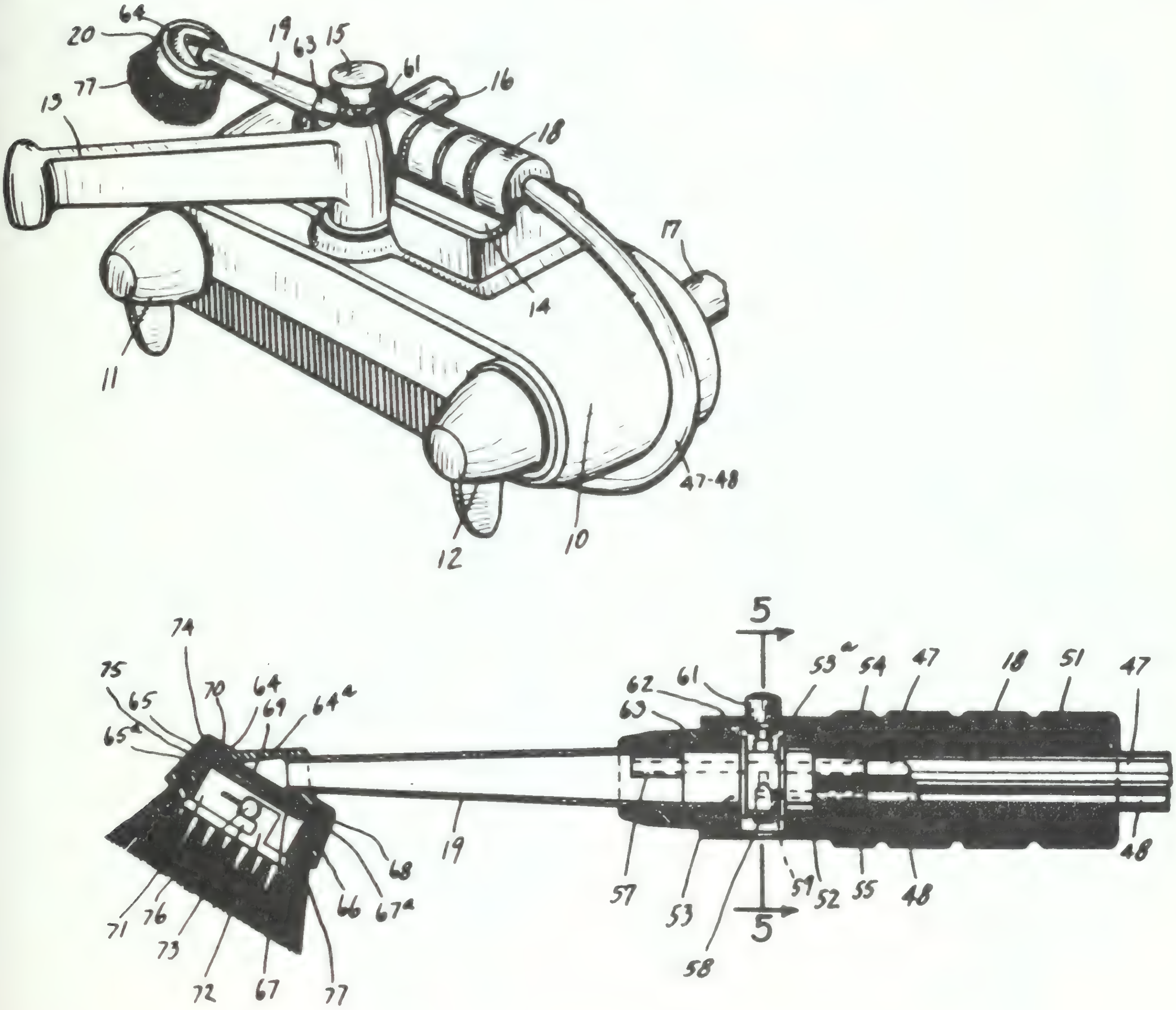
The Lewis Patent, Ex. O-9, shows a beverage dispenser which is apparently the same as the Wheco or Speed Bar device shown in Ex. B. This dispenser has a handle 10 with a nozzle mounted on the ends of a pair of flexible hoses 14 and 25. A valve operating lever 38 is mounted on the handle where it can be operated by the thumb of the hand which holds the handle so that a carbonated beverage is dispensed from the nozzle when the lever is operated.

Lewis Patent, Ex. O-9



Manville Patent, Ex. O-10, shows another dishwasher ith a handle 18 and nozzle 64 mounted on a double hose 47-48. valve 15 at the stationary end of the hoses controls the flow water through the hose 47, and a valve 61 on the handle controls the flow of soap through the hose 48.

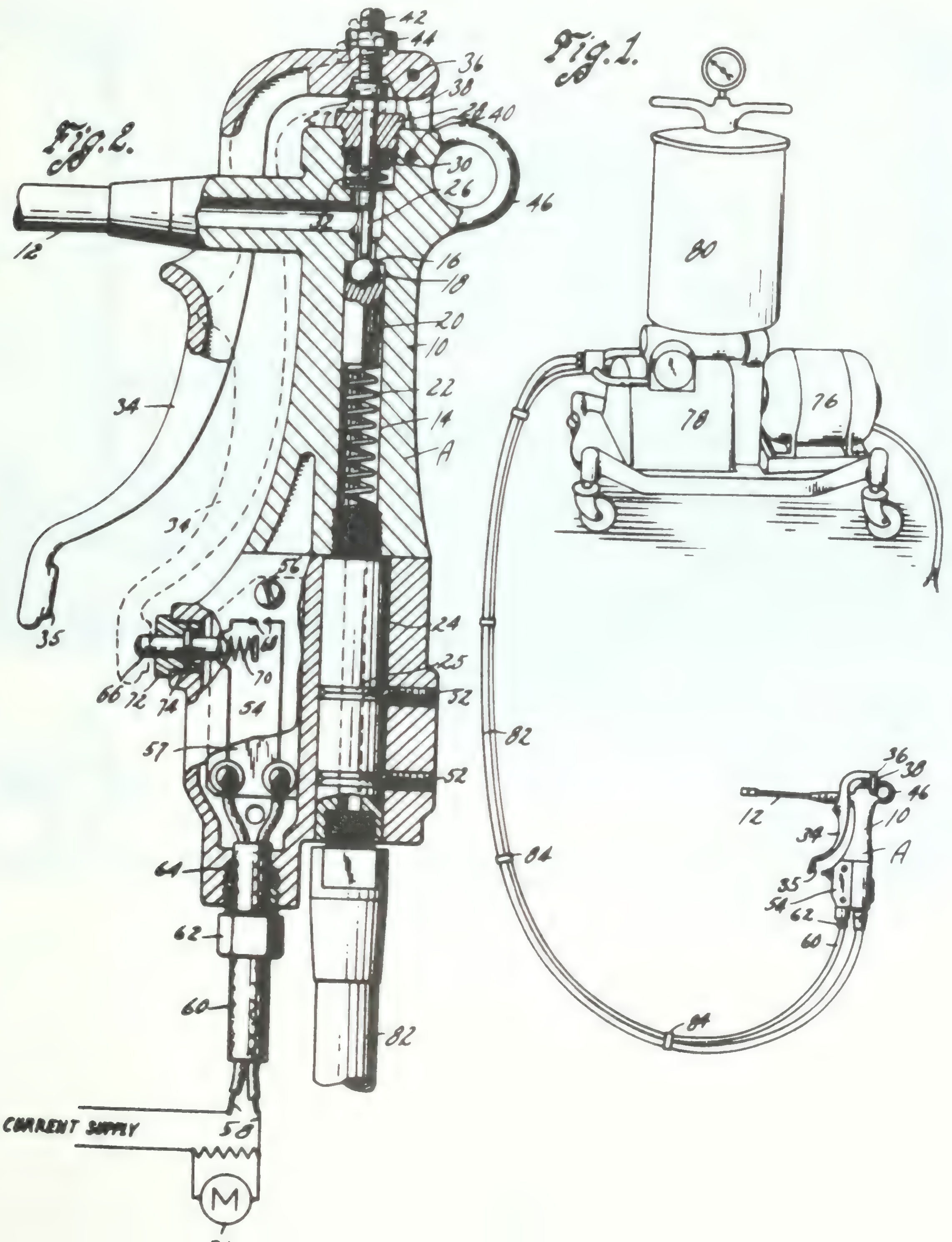
<u>Manville Patent, Ex. O-10</u>



The prior art illustrated above shows that it was ob-
ious in 1957 to one skilled in the dispenser art to mount valve ittons on flexible wand devices. If these patents constituted ie only prior art, Zilk might be able to argue that there was ome inventive distinction in relocating electrical valve switches istead of the valves themselves because these references don't each how to handle electricity. However, the prior art shown elow teaches that the relocation of electric switches onto the ind of the dispenser is old in the art.

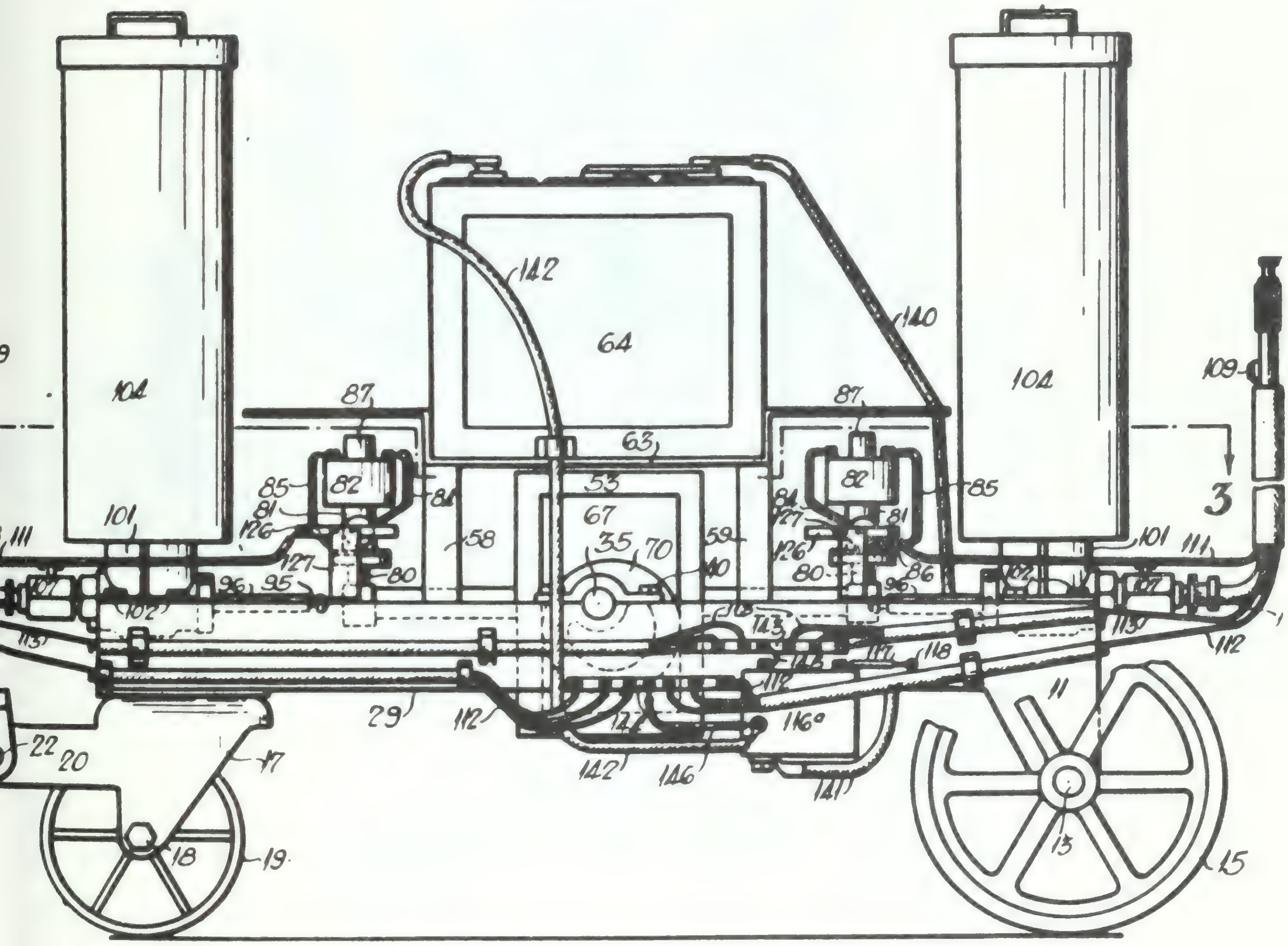
a handle A and nozzle 12 mounted on the end of a flexible hose 82. An operating lever 34 is mounted on the handle, and an electric switch 66 is mounted under the lever in position to be closed when the lever is operated. The switch is connected by wires 60 to control a motor, and several clamps 84 hold the wires 60 and the hose 82 together.

Carter Patent, Ex. O-2



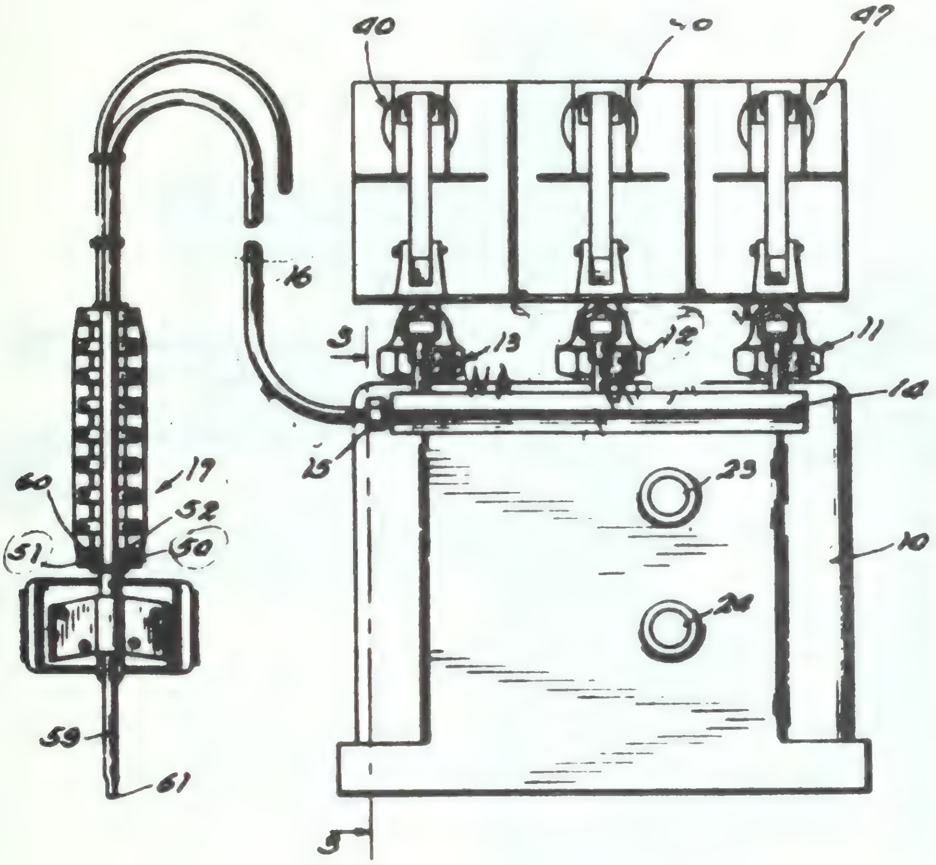
The Brown Patent, Ex. M, shows another lubrication de-
ice having several handles and nozzles 110, etc. mounted on lexible hoses with electric switches 109 mounted on the handles nd the electric wires for the switches are bound to the hoses y flexible covers.

Brown Patent, Ex. M



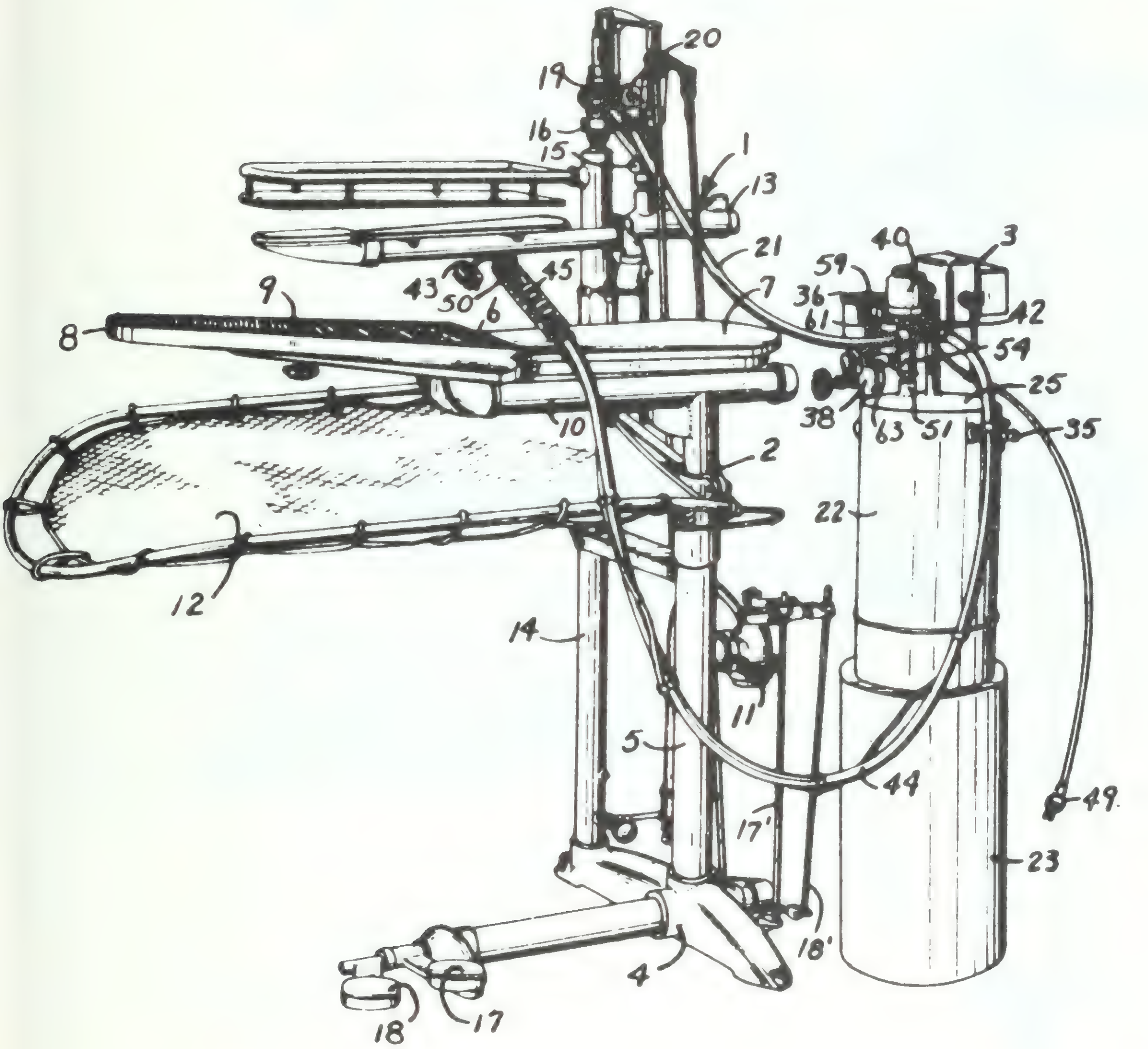
Miller, Ex. O-7, shows an electrically operated spotting gun with a handle 17 and nozzle 61 mounted on a hose 16 with two electrical switches 50 and 51 mounted on the handle where they can be operated by the thumb of the hand which holds the handle. The switches are connected by wires to solenoid valves in the same way that the switches and wires are connected in the Zilk device.

<u>Miller Patent, Ex. O-7</u>



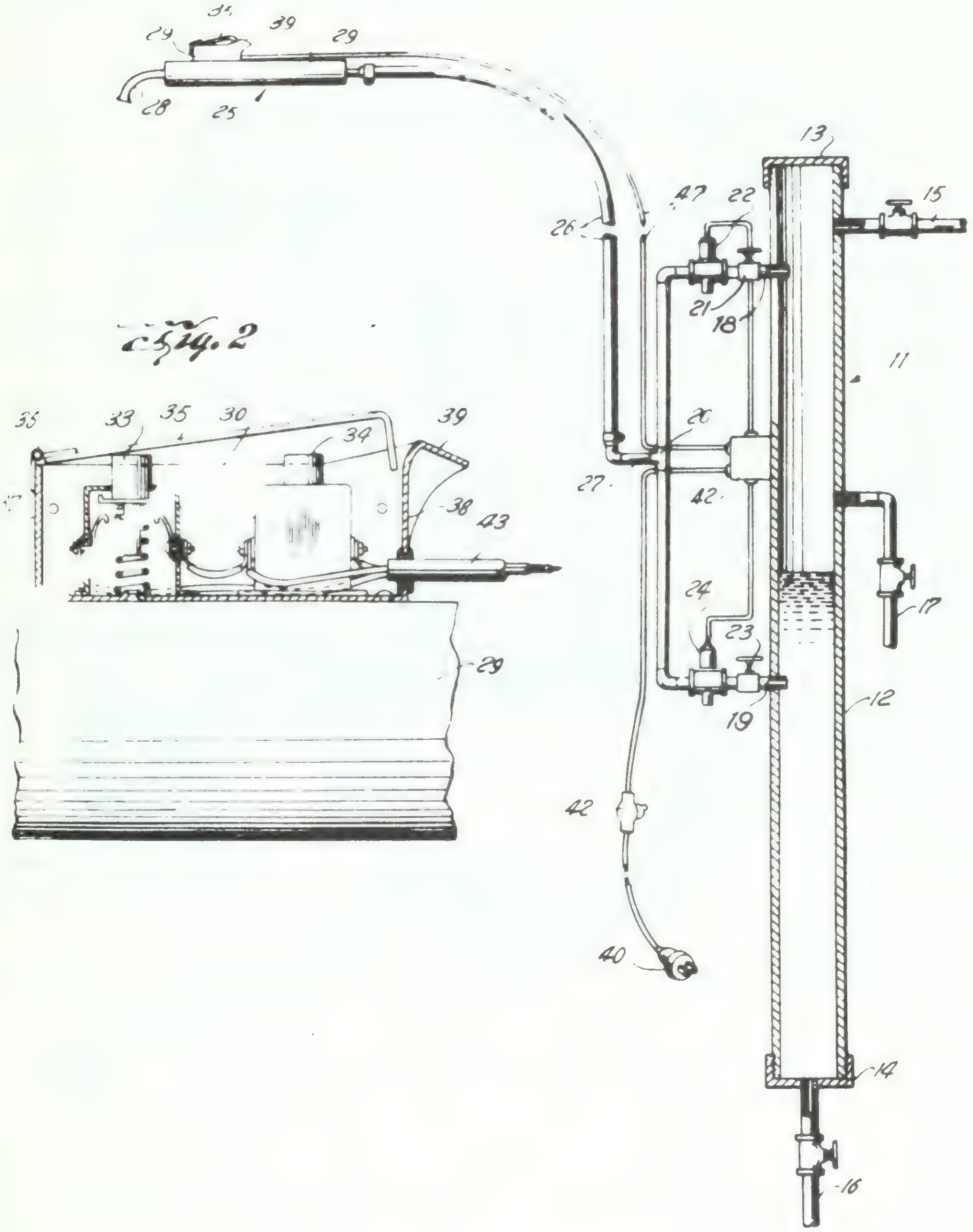
Butterbaugh, Ex. O-11, shows still another spotting un with a handle 45, nozzle 43, hose 44, and electric switch 50. he wires for the switch extend along the hose and are attached hereto by clips. The switches on the handle provide a one-anded operation so that the operator's other hand is free to anipulate the fabrics.

Butterbaugh Patent, Ex. O-11



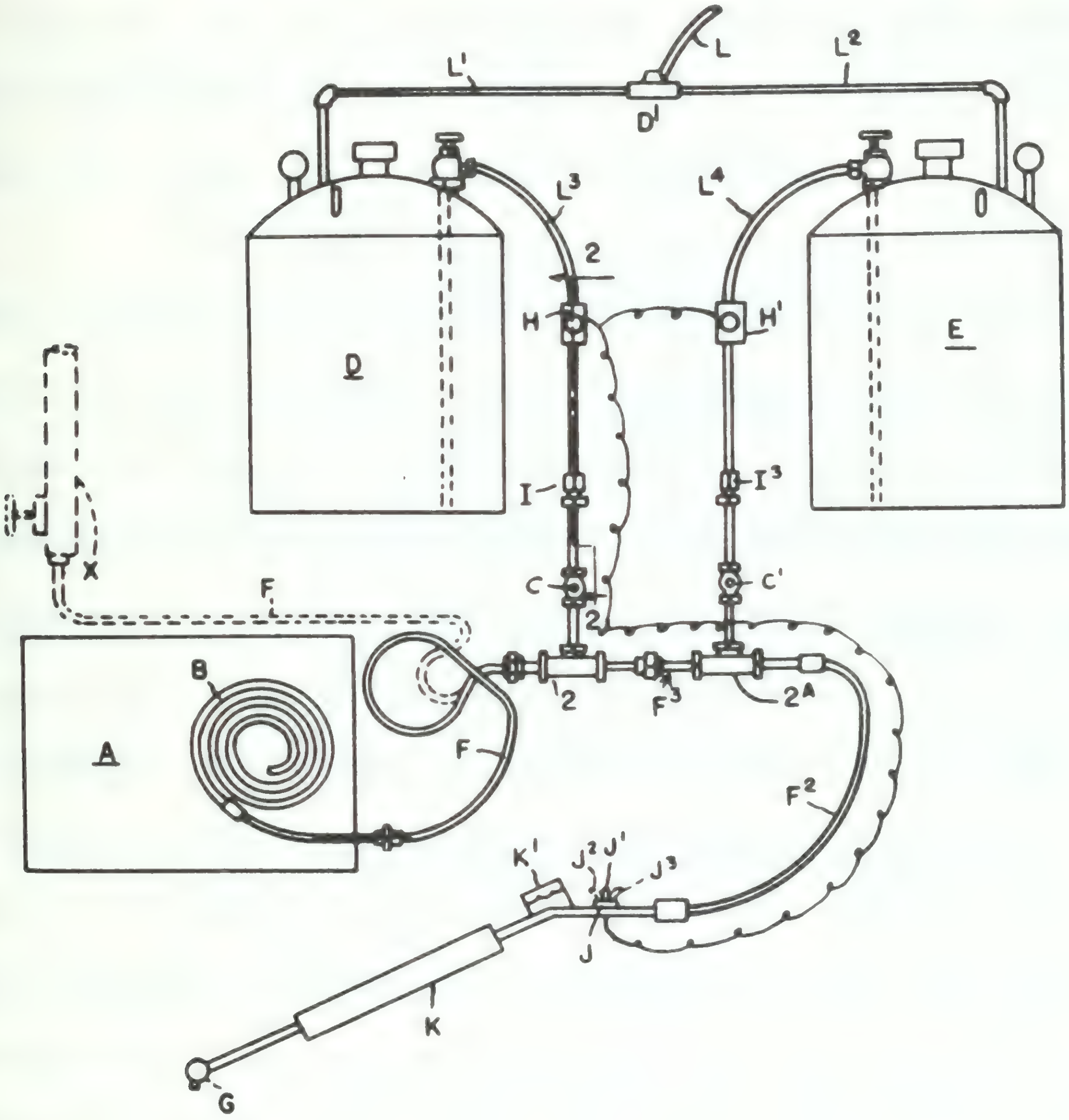
Walker, Ex. O-12, shows another spotting gun with a handle 25, nozzle 28, hose 26, electric wires and solenoid valves 22 and 24. An operating lever 35 on the handle operates two electric switches 33 and 34, as shown in Fig. 2.

<u>Walker Patent, Ex. O-12</u>



The Neilson Patent, Ex. O-13, shows a dispenser having a handle K and nozzle G mounted on a hose F. An electric switch J is mounted on the handle and connected by wires to solenoid valves H. The valves control the delivery of chemicals for treating surfaces prior to painting.

<u>Neilson Patent, Ex. O-13</u>



shown above are unimportant. What is important is the general teaching of the prior art as a whole. The prior art as a whole teaches that valve buttons and valve switches may be mounted on the handles of wand type dispensers to make the dispensers easier to use. This wide variety of devices with valves and switches mounted at the movable end of the hose shows beyond any possible doubt that it was within the skill of the art in 1957 to mount the operating push buttons of the Magic Wand on the movable end of the hose, and reasonable men on a jury could not find otherwise.

Appellants have pointed to only one fact in arguing that a reasonable jury could find the level of skill in the art at a lower level. Thus, Appellants point to Exhibit I which is a magazine article showing an early Barmaster device (Exhibit D) specially adapted with foot operated switches in place of the switch buttons on the valve block. Appellants argue that this publication shows that it was not obvious to Barmaster, the maker of the Magic Wand, to provide a one-handed operation by mounting the switch buttons on the movable end of the Magic Wand hose. There are several fallacies in this argument since, for instance, it does not appear in the record that the Magic Wand hose was even in existence to be improved upon at the time the device shown in Exhibit I was made. The Exhibit I device was apparently made prior to the March, 1957 date of Exhibit I, and the record does not indicate that the Magic Wand device was even in existence for any substantial period prior to July of 1957 when it was

been in existence at the time the Exhibit I device was made, the use of foot switches in Exhibit I instead of the mounting of push buttons on the handle of the Magic Wand provides substantially no inference of unobviousness because it appears from the face of Exhibit I that that structure was a special purpose installation. What the Exhibit I device does show is the fact that it was obvious prior to Zilk's invention to relocate the switches on Exhibit D to a different place where such relocation was beneficial.

The Section 103 Ground For The Judgment

As indicated in the preceding sections of this Brief, the factual matters considered in the application of §103 are either undisputed or so clear that reasonable men could not differ on them. The prior art Wheco and Magic Wand devices are shown in the Exhibits and easily understood. A comparison of these devices with Claim 1 of the patent shows the difference between the invention and the prior art; Zilk relocated the Magic Wand switches from their position on the bar mounted valve block to a position on the handle at the end of the hose. When postulated at "the minimum conceivable level", the level of skill in the dispensing art is such that it was conventional prior to 1957 to mount the operating switch or valve buttons for dispensers at the movable end of a flexible hose.

npatentable as a matter of law for failure to meet the ob-
iousness test of §103. As the District Court said, "Even if
he ordinary skill possessed by persons engaged in the bar dis-
ensing field were postulated at the minimum conceivable level,
ilk's dispensing device would clearly have suggested itself
s a possible solution to a person possessing such skill who
as given the 'Wheco' and 'Magic Wand' device and told to alter
t in such a way as to provide for one-handed dispensing of a
lurality of fluids." (CT. 264) It is submitted that this is
rue as a matter of law whether or not the men skilled in the
rt were told to alter the prior art devices to provide a one-
anded operation. Zilk did not invent a one-handed operation:
he Wheco device, as a competitive structure, had taught him
his feature. (RT. 55) Zilk merely realized, as a businessman,
hat it would be necessary to modify the Magic Wand device to
rovide for a one-handed operation if the device were to be
ompetitive with the existing Wheco device.

The "Standard of Invention" Ground for The Judgment

As indicated in the Statement of the Case in this
rief, the District Judge granted the Motion for Judgment
.o.v. on a second ground which was "entirely separate from
he Section 103 issue" (CT. 265). This second ground, which
as not submitted to the jury, (CT. 266), is based on the
ourt's holding that the Zilk invention does not obtain any
unusual or surprising consequences" which are required before

This is the standard of invention for combination patents announced in A & P Tea Co. v. Supermarket, supra. This test of "unusual or surprising consequences" is to be applied in addition to the test of §103. See Santa Anita Mfg. Corp. v. Lugash et al, -- F.2d., --, 152 USPQ 44 (9th Cir., Dec. 6, 1966), where the Court said:

> "In Bentley v. Sunset House Dist. Co., 359 F.2d 140, 144, 149 USPQ 152, 155 (9th Cir. 1966), we said:
>
> > 'In assessing the patentability of combination patents, we are to apply a 'severe test', whether 'the whole in some way exceeds the sum of its parts' to produce 'unusual or surprising consequenses from the unification of the elements * * *,' Great A & P Tea Co. v. Supermarket Equipment Co., 1950, 340 U.S. 147, at 152, 71 S.Ct. 127, at 130, 95 L.Ed 162, 87 USPQ 303, 305-306.'
>
> "It is apparent from the record and findings that the trial court tested patentability by the requirements of 35 USC §103, the test of obviousness. (E.g., Findings of Fact Nos. 18, 25, and 28, C.T. 666-69). Unquestionably these statutory requirements are prerequisite to the issuance of any patent. Graham v. John Deere Co., 383 U.S. 1, 148 USPQ 459 (1966). But in the special case of combination patents, the 'severe test' referred to in Bentley v. Sunset House Dist. Co.,

before a combination patent can be recognized. Zero Mfg. Co., Inc. v. Mississippi Milk Producers Ass'n, 358 F.2d 853, 149 USPQ 70 (5th Cir. 1966); Jeddeloh Bros. Sweed Mills, Inc. v. Coe Mfg. Co., (9th Cir.) 151 USPQ 679. The record in only one place reflects the application of this test to the patent in issue, which is admittedly a combination of old ideas. (Appellees' Brf. p. 51).

"Finding of Fact No. 8 is the only reference to a new function of the Lugash '227 loader. It is obvious from the authorities cited above that the test of a new function must be met or the patent is invalid. Therefore, in this case, logic dictates that if Finding of Fact No. 8 was clearly erroneous, then the judgment must be reversed. We believe we are required to hold that Finding of Fact No. 8 was clearly erroneous." (152 USPQ at 46, with emphasis added)

As the District Court noted at CT. 262, the Zilk device is a combination of "old" elements. The District Court found that this device did not produce any unusual or surprising consequences, and there is no evidence of any kind in the record from which the jury could have found otherwise, and for this reason, the Judgment n.o.v. was properly

the severe test of the A & P case. In this regard, it has long since been the law that mere relocation of an element of an old combination does not amount to patentable invention under the A & P Rule. See Photochart et al v. Photo Patrol, Inc., 180 F.2d 625, 90 USPQ 46 (9th Cir., 1951) Cert. denied 342 U.S. 867, where this Court said:

> "The test to be applied to such patents is that the combination must perform some new or different function -- one that has unusual or surprising consequences (citing the A & P case). It is our view that the patent in suit fails to meet this severe test and does not constitute invention. The most that can be said for the patent in suit is that it rearranges the elements of the slit camera in such a manner that in the performance of the respective functions a higher degree of accuracy is attained. But perfection of workmanship, however useful or convenient, does not constitute invention." (90 USPQ at 48)

APPELLEE'S MOTION FOR NEW TRIAL

In accordance with the provisions of F.R.C.P. Rule 50(c) quoted above, Appellee urges error in the District Court's failure to grant the Motion for New Trial. Rule 50

the failure to rule can be construed as a denial of the Motion it is requested that this Court either grant the Motion for New Trial or remand the case for determination of the Motion for New Trial in the event that the Judgment n.o.v. is vacated. The Motion for New Trial should have been granted because the jury was not instructed on the A & P Tea Co. test.

CONCLUSION

For the above reasons, it is respectfully submitted that the Judgment n.o.v. should be affirmed because (1) No reasonable jury could have concluded that the Zilk invention met the unobviousness requirement of 35 USC §103, and (2) The Zilk patent is invalid as a matter of law for failure to meet the requirement of unusual and surprising consequences set forth in A & P Tea Company v. Supermarket.

In the event that the Judgment n.o.v. were vacated, the case should be remanded for new trial or for a ruling by the District Judge on Appellee's Motion for New Trial, and for ruling by the District Court on the misuse defenses.

Dated, San Francisco, California,
February 6, 1967.

Respectfully submitted,

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Attorneys for Appellee

No. 21,194

United States Court of Appeals

For the Ninth Circuit

CARL S. ZILK and FLOMATIC SALES CORPORATION, an Oregon corporation,
Appellants,

vs.

DEATON FOUNTAIN SERVICE, a partnership comprised of William F. Deaton and C. J. DECEASARE,
Appellee.

APPELLANTS' REPLY BRIEF

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Subject Index

Table of Authorities Cited

The trial court concluded and appellee here argues that the judgment n.o.v. was proper because (a) the ultimate fact of nonobviousness found by the jury could be re-examined by the trial court as "a matter of law" (B. 6-9) and (b) the trial court could hold combination patent claims invalid, regardless of jury findings of nonobviousness, if it believes the combination does not meet a "standard of invention" set forth in *A. & P. Tea Co. v. Supermarket Corp.* (1950) 340 U.S. 147 which is in addition to the condition of nonobviousness prescribed in Section 103 (B. 34).

Appellee bases both arguments on several decisions[2] of this Court which preceded *Graham* and two which followed it.[3] The decisions which appellee cites seemingly conflict with other decisions of this Court such as *Moist Cold Refrigerator Co. v. Lou Johnson Co.* (9 Cir. 1957) 249 F. 2d 246 and *Hansen v. Safeway Stores* (9 Cir. 1956) 238 F. 2d 336 (cited by appellants O.B. 15, 30-31). *Moist Cold* and *Hansen* preserve the fundamental guaranty of the Seventh Amendment and leave to the jury its fact finding function on the present issue where there is substantial evidence to support jury findings. *Oxnard Canners v. Bradley* (9 Cir. 1952) 194 F. 2d 655, at pages 656-657, is to the same effect. But language in the series of cases, upon which appellee relies, appears to approve a reexamination of

[2]*Stallman v. Casey Bearing Company* (9th Cir. 1957) 244 F. 2d 905; *Griffith Rubber Mills v. Hoffar* (9th Cir. 1963) 313 F. 2d 1; *Berkeley Pump Co. v. Jacuzzi Bros.* (9th Cir. 1954) 214 F. 2d 785; and *Himes v. Chadwick* (9th Cir. 1952) 199 F. 2d 100.

[3]*Bentley v. Sunset House Distributing Corp.* (9th Cir. 1966) 359 F. 2d 140; and *Santa Anita Mfg. Corp. v. Lugash* (9th Cir. 1966) .... F. 2d ...., 152 U.S.P.Q. 44.

the very same fact issue by the court as "a matter of law" regardless of earlier jury findings or the substantiality of the supporting evidence. The latter may merely be "rhetorical embellishment" [*Graham v. John Deere* (1966) 383 U.S. 1, footnote 7, page 15] and the apparent conflict more seeming than real. However, since the general expressions in many of the cases seem to support arguments such as those which Deaton makes here, we urge that such general expressions should be treated with the respectful restraint noted by Chief Justice Marshall when he spoke for the Court in *Cohens v. Virginia* (1821) 6 Wheat. (19 U.S.) 264, 399:

> "* * * It is a maxim, not to be disregarded, that general expressions, in every opinion, are to be taken in connection with the case in which those expressions are used. If they go beyond the case, they may be respected, but ought not to control the judgment in a subsequent suit when the very point is presented for decision. The reason of this maxim is obvious. The question actually before the court is investigated with care and considered in its full extent. Other principles which may serve to illustrate it, are considered in their relation to the case decided, but their possible bearing on all other cases is seldom completely investigated. * * *"

If this were not so, then the universal treatment of non-obviousness as a question of law for which Deaton argues on this appeal, although seemingly supported by general expressions in some of the cases, would, when tested in the light of the present record, conflict with the fundamental guaranty of the Seventh Amendment as the issue of non-obviousness has now been framed by the Supreme

Court in *Graham* and as the issue of invention in jury trials had been framed by the same court in its earlier decisions.

Denial of the right of trial by jury may be an "age-old proposition" (B. 6) but that is no reason for curtailing the constitutional guaranty in a patent claim for damages or in any other litigation. Mr. Justice Black observed in *Beacon Theatres v. Westover* (1959) 359 U.S. 500, 501:

> "* * * 'Maintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in our history and jurisprudence that any seeming curtailment of the right to a jury trial should be scrutinized with the utmost care.' *Dimick v. Schiedt,* 293 U.S. 474, 486."

The Supreme Court again recently reaffirmed the importance of the jury as fact-finder in damage claims in *Dairy Queen v. Wood* (1962) 369 U.S. 469 and *Shubin v. U. S. District Court* (1962) 369 U.S. 660.

In advocating this cause we are not unaware of the duty of a trial court, recognized in the Seventh Amendment itself, to remove even a fact issue from jury determination, if the evidence is such that reasonable men could not differ in resolving it. That, we submit, is the only basis upon which the issue of nonobviousness could have been, but was not, taken from the jury here. That is the proper and only basis for rendering or for review of a judgment n.o.v. as this Court held in *Moist Cold Refrigerator Co. v. Lou Johnson Co.* (9 Cir. 1957) 249 F. 2d 246 and *Hansen v. Safeway Stores* (9 Cir. 1956) 238 F. 2d 336 (cited O.B. 15, 30-31).

As we pointed out (O.B. 28), there are two types of jury fact issues. One is resolution of controverted evidence which appellee recognizes (B. 8-9). Another is resolution of fact issues of debatable quality upon which "fair minded men might reach different conclusions" where the basic facts are not controverted [*Bailey v. Central Vermont Ry.* (1943) 319 U.S. 350, 353]. Negligence, scienter and, we submit, nonobviousness are issues of the second type [*Moist Cold Refrigerator Co. v. Lou Johnson Co.* (9 Cir. 1957) 249 F. 2d 246].

Here record evidence supports the jury finding of nonobviousness and the case history confirms its substance. Reasoning minds did reach different conclusions from the same evidence. Twelve jurors unanimously made specific findings that the Zilk dispenser was not obvious (CT. 185b-185e; Interrogatories 2, 4, 6, 8, 10, 12, 14 and 16) and one trial judge found that it was (CT. 260-65). With this record how can anyone now argue that reasonable men could not differ on the factual issue in controversy?

Substantial record evidence does support the jury finding of nonobviousness

Appellants' opening brief classifies four types of record evidence from each of which the jury could, we submit, as it did, conclude that the patented dispenser construction was not obvious (O.B. 26-31).

Appellee's own discussion of the Magic Wand and Speedbar devices (B. 12-17) and fourteen other prior art dispensers, some well known for over thirty years, and including the full range from gas torches to dishwashers (B. 18-32), confirms the nonobviousness of the patented

dispenser. The jury found that not one of all these devices used the combination of elements recited in the Zilk patent claims (CT. 185b-185e, Interrogatories 1, 3, 5, 7, 9, 11, 13 and 15). Neither the trial court nor appellee questioned this finding of fact.

The impact of this volume of prior art is manyfold. It certainly shows the state of the prior art and may be evidence of the ordinary skill in this art, as appellee asserts (B. 32). But, far from showing obviousness, the very fact that no one adopted and used the Zilk combination, even though all the component parts were known for years, is positive proof that the Zilk combination was not obvious. The Supreme Court in *Loom Co. v. Higgins* (1881) 105 U.S. 580, 591 (cited O.B. 29) so held as follows:

> "It is further argued, however, that, supposing the devices to be sufficiently described, they do not show any invention; and that the combination set forth in the fifth claim is a mere aggregation of old devices, already well known; and therefore it is not patentable. This argument would be sound if the combination claimed by Webster was an obvious one for attaining the advantages proposed,—one which would occur to any mechanic skilled in the art. But it is plain from the evidence, and from the very fact that it was not sooner adopted and used, that it did not, for years, occur in this light to even the most skillful persons. It may have been under their very eyes, they may almost be said to have stumbled over it; but they certainly failed to see it, to estimate its value, and to bring it into notice. * * * we cannot yield our assent to the argument, that the combination of the different parts or elements for attaining the object in view was so obvious as to merit no title to invention. Now that it has succeeded, it may seem very plain to any one

> that he could have done it as well. This is often the case with inventions of the greatest merit. * * *"

Appellee also argues that "substantially no inference of nonobviousness" can be drawn from the Barmaster foot pedal device because it was a "special purpose installation" (B. 33) and may have been made before the Magic Wand hose (B. 32). Deaton's candid use of "substantially no" in its criticism virtually admits that reasonable minds could draw "some" inference of nonobviousness from this evidence as appellants have shown (O.B. 26-29). The fact remains that both the foot treadle device and the Magic Wand hose did exist simultaneously and Barmaster, which manufactured both, did not perceive the combination that Zilk later made from the very same elements. If appellee can infer that the foot pedal device shows it was obvious to relocate pushbuttons, certainly the jury could infer from Barmaster's relocation of them on foot treadles or its failure to relocate them at all on the Magic Wand, that it was not obvious to arrange pushbuttons on the handle as did Zilk for single-grip one-handed dispensing of multiple fluids.

Appellee does not discuss at all the evidence proving a shift of the bar dispenser industry to the Zilk dispenser from a variety of prior art bar dispensers, like the Magic Wand, which were abandoned (O.B. 30, 31). This Court in reversing a judgment n.o.v. held that a jury could infer nonobviousness from this very same type of evidence in *Moist Cold Refrigerator Co. v. Lou Johnson Co.* (9th Cir. 1957) 249 F. 2d 246 at 254 (cited O.B. 30). Appellee's failure to respond on this point is a tacit admission of the substantiality of those proofs.

We submit that the four classes of evidence which appellants discussed are sufficient to support the jury finding of nonobviousness under proper restraint of the judicial power as was outlined in the *Moist Cold* and *Hansen* cases. Indeed, the sheer volume of prior art offered by appellee—none of which uses the Zilk combination of elements—in and of itself is conclusive evidence of nonobviousness.

Recognizing the substantiality of the evidence in this record to support the jury finding of nonobviousness, the trial court in its decision did, and the appellee here seeks to, convert the ultimate fact issue of nonobviousness into one "of law" and by that means reserve it for determination solely by the court.

Nonobviousness—in its entirety—is an ultimate fact to be determined by the jury

Appellants have shown that nonobviousness in its entirety is an ultimate fact to be determined by the jury (O.B. 15-21). Deaton's dissection (B. 9) of the issue—a preliminary part for the jury but the critical part for the court—strikes at the very heart of a jury trial on this issue. After conceding that (1) the scope and content of the prior art, (2) what Zilk did to improve upon the prior art, and (3) the level of ordinary skill in the art, are fact determinations for the jury, Deaton argues that the ultimate fact of (4) whether or not the improvement was obvious should be snatched from the jury and decided by the court.

That is not the practical test announced in *Graham v. John Deere Co.* (1966) 383 U.S. 1 (O.B. 15-19). That also

is not the law announced by the Supreme Court in its earlier decisions in jury cases such as *Hotchkiss v. Greenwood* (1851) 11 How. (52 U.S.) 248 and *Keyes v. Grant* (1886) 118 U.S. 25 or in *Thomson Co. v. Ford Motor Co.* (1924) 265 U.S. 445 (cited O.B. 19-21). Deaton does not dispute or even discuss, the clear holding in *Keyes v. Grant* (1886) 118 U.S. 25, 37 that the whole issue of invention (now nonobviousness) is "a question of fact properly to be left for determination to the jury". We find no decision of the Supreme Court which has overruled or limited the holding in *Keyes*.

The court in *Graham v. John Deere Co.* (1966) 383 U.S. 1, being a non-jury case, did not expressly pass upon the issue. But the opinion likens the issue of nonobviousness to issues of negligence and scienter (383 U.S. 18). Both are determinations in their entirety for consideration by the jury. In a negligence situation the jury determines the conduct of the alleged tort-feasor, determines the standard of conduct of the reasonably prudent man in the same situation and then determines whether the alleged tort-feasor has met or not met that standard. The latter is not withdrawn for the court to determine as "a matter of law", but the entire issue is decided by jury. Here then, in the similar frame of reference of Section 103, not only are (1) the state of the prior art, (2) the improvement made by the patentee and (3) the level of ordinary skill in the art, facts for determination by the jury, but also, (4) the ultimate fact of obviousness or nonobviousness of that improvement is for jury determination. The Court nowhere in its *Graham* opinion expressly or implicitly stated that the ultimate fact (4) was to be determined any

differently than the underlying facts (1) through (3) (383 U.S. 17). The court nowhere stated or implied that the ultimate fact (4) should be determined "as a matter of law".

Moreover, appellee's dissection of the ultimate finding of (4), what would be obvious to those of ordinary skill, from determination of (3), the ordinary skill in the art, is unrealistic and cannot provide the "practical test" envisioned by the Supreme Court in *Graham*. The two are interdependent. What would be obvious in each case depends upon the level of skill—both of necessity must be determined by the same fact finder.

Appellee argues (B. 6) that because the court in *Graham* stated (383 U.S. 17) that "the ultimate question of patent *validity* is one of law (emphasis added)", the jury verdict somehow is no longer sacrosanct on the issue of nonobviousness.[4] The full text of the statement to which appellee refers is

> "While the ultimate question of patent validity is one of law, A. & P. Tea Co. v. Supermarket Corp., supra, at 155, the Section 103 condition, which is but one of three conditions, each of which must be satisfied, lends itself to several basic factual inquiries. * * *"

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[4]This statement in *Graham* precedes a citation to the concurring opinion of Justice Douglas in *A. & P. Tea Co. v. Supermarket Corp.* (1950) 340 U.S. 147, 155 where he supported a similar statement concerning *validity* with *Mahn v. Harwood* (1884) 112 U.S. 354, 358. There the court considered not obviousness or invention, but the propriety of reissuing a patent with claims broader than the original. Moreover, neither *A & P* nor *Mahn* was a jury case.

Observe that the Court referred only to validity as "one of law" and to obviousness as "several basic factual inquiries".

Appellee and the lower court, as well as this Court in *Bentley v. Sunset House Distributing Corp.* (9 Cir. 1966) 359 F. 2d 140, 143 (quoted B. 6-7), ignore that validity is not synonymous with nonobviousness, which is the principal issue here. All seize upon the statement that "the question of patent validity is one of law" to conclude that one facet of the validity issue—nonobviousness—also must be a question of law (B. 6). That conclusion not only is irreconcilable with the nature of the issue as characterized in the *Graham* decision, but also, is contrary to the specific holding in *Keyes v. Grant* (1886) 118 U.S. 25, 37.

The Supreme Court itself in the above *Graham* quotation recognized that the multiple issue of validity includes, among other things, compliance with the conditions of patentability, that is, utility and novelty in Sections 101 and 102 *and* the Section 103 condition (383 U.S. 17). In addition, of course, the issue of validity involves other formal requirements of the patent statute such as fullness of disclosure and definiteness of claiming found in Section 112. While the trial court may "as a matter of law" ascertain compliance with each statutory requirement for patentability, it does not follow that the trial court in a jury case properly can reexamine each factual issue upon which compliance or non-compliance is based. Not even appellee argues that the court properly can reexamine the nature of the prior art found by the jury or the level of skill in the art, for example (B. 9).

Appellee cites no Supreme Court authority which holds that nonobviousness under Section 103 can be decided "as a matter of law" in a jury case. The decisions of that court are to the contrary (O.B. 19-21).

All of the appellate court decisions which Deaton does cite for this proposition (B. 6-12), except *Bentley v. Sunset House Distributing Corp.* (9 Cir. 1966) 359 F. 2d 140 and *Walker v. General Motors Corporation* (9 Cir. 1966) 362 F. 2d 56, were rendered before the Supreme Court classified nonobviousness with the factual issues of negligence and scienter in its *Graham* decision. It does not appear that in any case the jury had made a specific finding of nonobviousness. Hence, none faced the specific constitutional issue presented here.

In *Walker,* this Court had before it only a decision on summary judgment. There was no jury finding of nonobviousness which presented the constitutional issue. In *Bentley* this Court did approve a judgment n.o.v. which set aside a general verdict for the patentee (B. 6). But in that suit the jury did not make a specific finding of nonobviousness which the trial court set aside, as was done here (Docket No. 19,453; RT. 499). In that suit, too, the trial court did not set aside the general verdict because the court thought it could reexamine a jury finding of nonobviousness as "a matter of law", as was done here. Instead, it held there was "no substantial evidence to uphold any of the counts alleged by Plaintiff" and that the mechanical patent in question was "fully anticipated" by the patentee's own design patent (Docket No. 19,453, CT. 385). Thus, the trial court in *Bentley* had not re-

examined facts specifically found by the jury as "matters of law" or had not applied a test for the requisite "level of innovation" apart from Section 103. *Bentley* did not present the constitutional issue which is manifest on this appeal.

In any event, we submit that, insofar as any of the appellee's authorities seemingly approve reexamination by the trial court of the ultimate fact of nonobviousness which had been found by the jury, the decision should not be perpetuated here because it conflicts with *Keyes v. Grant* (1886) 118 U.S. 25 and violates the guaranty of the Seventh Amendment as nonobviousness is now framed in *Graham v. John Deere Co.* (1966) 383 U.S. 1. It also cannot be reconciled with such decisions of this Court as *Moist Cold Refrigerator Co. v. Lou Johnson Co.* (9 Cir. 1957) 249 F. 2d 246; *Hansen v. Safeway Stores* (9 Cir. 1956) 238 F. 2d 336 and *Oxnard Canners v. Bradley* (9 Cir. 1952) 194 F. 2d 655.

The "general level of innovation necessary to sustain patentability" is the condition of nonobviousness codified in Section 103

Appellants discussed (O.B. 23-25) the conclusion in *Graham v. John Deere Co.* (1966) 383 U.S. 1, 17 that Section 103 codified the various attempts to define "invention" which were found in earlier case law including *A. & P. Tea Co. v. Supermarket Corp.* (1950) 340 U.S. 147. We submit that there is no test for the "general level of innnovation necessary to sustain patentability" which must be applied in addition to that provided in Section

103. Nonobviousness and the requisite level of innovation are one and the same thing.

The Supreme Court in *Graham* dealt with combination patents. It applied the four step functional test to the patents there in suit which it described (383 U.S. 17). It did not apply some further test of "unusual or surprising consequences" which appellee here argues must be met by a combination patent in addition to nonobviousness under Section 103. The *Graham* opinion clearly held that, henceforward, the courts should adhere to its four step test for nonobviousness rather than apply such inadequate tests for the requisite general level of innovation as "the flash of creative genius" (383 U.S. 15) or "unusual and surprising circumstances" and "the whole in some way exceeds the sum of its parts" of *A. & P.* (383 U.S. 17-18).

We submit that appellee, the trial court, and this Court in *Bentley v. Sunset House Distributing Corp.* (9 Cir. 1966) 359 F. 2d 140 and *Santa Anita Mfg. Co. v. Lugash* (9 Cir. 1966) .... F. 2d .... are wrong insofar as they require any test in addition to one for nonobviousness under Section 103. The "severe test" to which this Court referred in those cases is and can only be the test for obviousness set forth by the Supreme Court in its *Graham* decision. And the fact of nonobviousness here had already been found by the jury and should not have been re-examined by the trial court on this basis.

The asserted error regarding new trial

Appellee urges as error (B. 5) the failure of the trial court to rule on its motion for new trial which was filed

concurrently with the motion for judgment n.o.v. In this, the trial court may not have followed rule 50(c)(1), but it was not an error prejudicial to appellee.

As a basis for new trial Deaton argues that the court failed to instruct the jury on the "*A & P Co.* test" (B. 38). This argument is preposterous. Deaton had requested the court to give *A & P* instructions, 7 and 10 quoted below,[5] and the court had decided to give them. But, then at the last moment just prior to instructing the jury, appellee withdrew those two instructions and they were not given (RT. 342). Deaton is not candid with this Court when it now urges, as basis for new trial, a failure to give instructions which it asked the court *not* to give. Indeed, Deaton is precluded by Rule 51 from even assigning as error the court's failure to give the withdrawn instructions [F.R.C.P. 51].

We submit that this Court should reverse the judgment n.o.v. for the reasons briefed by appellants. If it does, the jury verdict should be reinstated and no remand made to consider a new trial on such a patently overreaching

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[5]"7. The conjunction or concert of known elements must contribute something; only when the whole in some way exceeds the sum of its parts as the accumulation of old devices patentable. When two and two have been added together and still they make only four, the sum is not a patentable invention.
Authority *Great A and P Tea Company v. Supermarket Equipment Corp., 340 US 147.*"

"10. A combination of old elements is patentable invention only if the elements take on some new quality or function by being brought into concert and their combined results in unusual or surprising consequences.
Authority, *Great Atlantic and Pacific Tea Company v. Supermarket Equipment Corp., 340 US 147 (1950). Farco v. American Air Filter Company, Inc., 318 F 2d, 500, 137 US PQ 627 (CA 9).*"
[RT. 296-7]

basis [*Harp v. Montgomery Ward & Co.* (9 Cir. 1964) 336 F. 2d 255, 261].

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February 25, 1967.

Respectfully submitted,
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